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NEW DIRECTIONS FOR DEALING WITH THE INTERNATIONAL DEBT PROBLEM

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

TO REVIEW PROPOSALS FOR ADDRESSING THE DEBT BURDEN OF THE DEVELOPING COUNTRIES AND TO REVIEW THE INTERNATIONAL DEBT ISSUE FROM THE STANDPOINT OF THE STABILITY OF THE UNITED STATES AND THE WORLD FINANCIAL SYSTEMS AS WELL AS FROM THE POINT OF VIEW OF TRADE AND FOREIGN POLICY INTERESTS

AUGUST 2 AND 4, 1988

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NEW DIRECTIONS FOR DEALING WITH THE INTERNATIONAL DEBT PROBLEM

TUESDAY, AUGUST 2, 1988

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 2:05 p.m., in room SD-538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

Present: Senators Sarbanes, Dixon, Graham, Heinz, and Shelby.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The subcommittee will come to order.

We are expecting additional members to arrive, but there is a vote scheduled at 2:30, for which we will have to break and then return.

We can get perhaps the opening statements out of the way.

This is the first of two hearings, one this afternoon and another one on Thursday morning, which the Subcommittee on International Finance and Monetary Policy will hold this week on the issue of international debt. The purpose of the hearings is to review proposals for addressing the debt burden of the developing countries.

In the spring of last year the subcommittee held a series of three hearings to review the international debt issue from the standpoint of the stability of the United States and the world financial systems as well as from the point of view of trade and foreign policy interests.

Since that time there have been a number of significant developments on the debt issue. The U.S. money center banks made the decision to increase significantly their reserves against Third World loans. A new loan package was negotiated with Mexico and negotiations are currently underway with Brazil and Argentina.

Despite these developments, considerable concern about the issue remains. The joint communique from the economic summit in Toronto called for increased attention to the problems of the debtor countries and, in fact, proposed a specific debt relief scheme for the poorest of the African debtors. At the same conference, the Japanese floated a proposal to deal with a Latin American debt issue.

Prior to the summit, President Mitterrand of France had put forward a proposal to deal with the problem of African debt. In June, the IMF Director, Cambesis, gave a speech in which he spoke of the need "to reinvigorate the collective debt strategy."

A distinguished group of economic statesmen issued a statement in June prior to the Economic Summit, warning of the danger of complacency in dealing with the debt issue. In addition, there have been any number of proposals put forward by former Government officials from the United States and from other countries, commercial bankers, economists, businessmen and others, suggesting ways to reexamine the approach for dealing with the debt issue.

The reasons for continued concern about this issue are clear, although U.S. commercial banks have increased their reserves against Third World loans. Their holdings of developing country debt are still quite significant, particularly in money center banks.

United States trade to the highly indebted countries has been particularly affected by the debt issue. Imports to the United States from the 17 highly indebted countries have grown from $25 billion in 1978 to over $44 billion in 1986, an increase of 75 percent.

At the same time, U.S. exports to those countries declined by over 30 percent between 1981 and 1986. The need for the developing countries to expand exports and decrease imports in order to earn foreign exchange to pay their debts has driven them from running trade deficits, the common approach for countries seeking to develop their economies, to running trade surpluses.

Finally, the foreign policy consequences of the international debtor problems should not be underestimated. The World Bank estimates that in 1987, the 17 heavily indebted developing countries had a net transfer of capital resources of $29 billion out of these countries. That is not a sustainable situation, either economically or politically, and I might note that in many of the countries, newly arrived or returned more accurately to democracy and stability and viability of the political system is itself at stake.

For the time, it is clearly appropriate to reexamine the approach for dealing with the international debt problem.

The trade bill, which we hope to take up today or tomorrow on the floor of the Senate, contains in it provisions addressed to the debt problem, essentially setting up a process to examine it, not actually setting out a substantive solution, but seeking simply to draw the United States into a process to begin to examine this problem in a practical and sensible way.

In my own views, ways need to be found for the major industrial countries which are running large current account surpluses to recycle some of those surpluses to help deal with the debt problems of the developing countries. It is one way that strong economies which have developed over the postwar interim period can make a contribution by assuming a larger share of responsibility in this particular area.

I think the subcommittee is very fortunate in having an exceptionally distinguished group of witnesses over the 2 days of hearings to address these issues.

On Thursday we will hear from two panels, one a panel of bankers and a panel of academics and observers of this important issue.

Our second panel today will include Eugene Rotberg, currently executive vice president of Merrill Lynch and former Vice President and Treasurer of the World Bank, and the Honorable Rodrigo Botero, a visiting scholar at the Harvard Center for International

Relations, and Co-Vice Chairman of the Inter-American Dialogue and formerly the Finance Minister of Colombia.

I am particularly pleased that we have as our first and lead-off witness, Mr. James Robinson, the chairman of American Express, who has put forth, I think, some very interesting and constructive ideas, actually more than ideas. He has really developed a very significant proposal in this area, and he's been playing, I think a leading and constructive role on this issue.

The simple fact that these gentleman and many others feel it necessary that we reexamine the current approach to the debt issue is strong evidence in and of itself for the need for some reassessment.

With that by way of an opening statement, Mr. Robinson, we would be very pleased to welcome you before the committee and we look forward to hearing your testimony.

I will yield first to my colleague, Senator Shelby of Alabama.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman. I will try to be brief. I too welcome Mr. Robinson to the committee. I know he is way out front on some of the ideas that we are trying to deal with.

Mr. Chairman, I am happy that you scheduled these hearings because international debt is a very important issue. Indeed, it has been our foremost concern over our banking industry to strengthen this country. The LDC debt crisis has only been overshadowed in the news by that other dark cloud over the financial landscape, the thrift crisis. This committee, the Banking Committee in the Senate, has had a banner day here today, discussing the thrift industry's problems this morning and international debt this afternoon.

Globally, international debt is a bigger problem. The least developed countries owe our banks over $100 billion. While some progress has been made in instituting economic reforms in the less developed countries, current account and trade deficits have become smaller and debt service ratios have been reduced, and in some cases, public sector deficits have been cut. The debtor nations still have a long way to go.

Our first witness, Mr. Robinson, who is a leader in the discussion over Third World debt, warns us of debt fatigue. Measures of economic austerity are politically unpopular and citizens of these countries are beginning to clamor for relief, yet all prescriptions for a solution include continued aid to debtor nations to increase investment and thus stimulate growth.

Thus, the antidote for that which has plagued our banks is continued exposure to the risks of Third World entity. That is, continued lending. I am interested in all the plans that would hopefully cure our banks of this sickness; however, I want to ensure that our antidote is a vaccine. Continued injections of capital should provide for future prosperity in the lesser developed countries and made them capable in the long run of servicing their debt. That should be our goal. It should not merely increase their debt load and burden our own banks.

The solutions to the problem are difficult. I admire the work that our witnesses have done today, and I look forward to their new ideas.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much.

Mr. Robinson, we are happy to hear from you.

STATEMENT OF JAMES D. ROBINSON III, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMERICAN EXPRESS CO.

Mr. Robinson, Thank you very much. Mr. Chairman, Senator Shelby, members of the subcommittee.

I very much appreciate this invitation to be here and thank you for your words. I feel like I should say—"And are there any questions?"—because you have summarized very effectively, as I see it.

It is especially timely to hold these hearings, because it is clear that U.S. foreign policy, economic policy, and monetary policy are becoming more closely linked than ever. The LDC debt is a serious problem on all three policy agendas. I think it is useful to stop for a moment and say: For whom is it a problem?

Certainly for the national banks, their managements, their shareholders.

Certainly for the major debtor countries, the poor countries in Africa and the 17 heavily indebted middle income countries, especially those in Latin America.

But that really is only a part of the list. Here is the broader count of the victims or the stakeholders of LDC debt.

VICTIMS OF LCD DEBT

First, the people of the debtor countries, who are paying the price of austerity, inadequate domestic growth and no funds for investment.

Second, many political leaders in those countries, who are trying to meet their external obligations at the cost of domestic prosperity.

Third, the companies in industrial countries who have lost export markets, because LDC imports have been sharply curtailed, and with that has come the loss of jobs, the loss of profits and the tax revenues for the host governments.

Fourth, all of us, because of the potential destabilizing impact that a crisis can have on the world financial system and, in fact, on our collective national security.

We are here 10 days away from the sixth anniversary of the emergence of the LDC debt crisis. For most of that period, governments of the industrial countries have been treating LDC debts primarily as a banking problem, a problem for the banks and the debtor countries to resolve.

Certainly, troubled LDC loans and bank portfolios have been a potential threat to the banking system, a time bomb, in fact. But, more fundamentally, LDC debts are also a trade problem, an economic growth problem and a geopolitical problem.

As a businesman, I believe greater focus needs to be placed on these broader dimensions as we look at the more creative ways to address the LDC debt issue.

That is the perspective that I had in mind when I offered my proposal in late February.

The gist of that proposal was the creation of a new international entity which I called the Institute of International Debt and Development or I2D2, for sort. I2D2, would be a joint venture of the IMF and the World Bank.

I will touch on that a little later.

Now I introduced that proposal principally to help accelerate the dialog, the need for new ideas and new purposes. Since then, I'm delighted to say that the debate has broadened substantially and more attention has been paid and more proposals have been offered or reactivated. In fact, your work, Mr. Chairman, and that of the subcommittee, has contributed importantly to this heightened attention.

Basically, the debate has sorted itself out into two camps: those who think that the present approach one day will be adequate; and those who think that the present approach, while important, is not enough. Clearly, I fall into the latter category.

Well, by participating in and listening to the dialog over the past several months, I've drawn a few conclusions. First, the broader dimensions of the problem are real and cannot be adequately addressed without much greater involvement of the leading developed country governments, either directly or through the World Bank and the IMF.

Second, there are many valid approaches and packaging of approaches for providing significant additional funds for investment, either through debt relief or through credit enhancement. In short, the options are there. They are plentiful, if the strategic and political will of both developed and developing countries are there too.

Third, regardless of which option is selected to provide funds for investment, I believe that a new entity is needed to act as an international reorganization facility. This could be a new facility—as I've suggested, a joint venture—or it could be simply a branch of the IMF or World Bank. I favor the former, of course, because it emphasizes and places a special focus on the broader dimensions of the problem and best allows a new entrepreneurial initiative to be launched. There are precedents for that kind of joint venture betweem the World Bank and the IMF.

THE BAKER PLAN

Almost 3 years ago, Treasury Secretary Jim Baker announced a program for dealing with LDC debt. And that program has been a good framework, because it shifted the emphasis to growth instead of austerity alone. The Baker plan, importantly, has bought time, allowing the banks to build the capital to establish their reserves. Still, the current strategy has so far only held the line. It has not marshaled adequate resources to restore LDC's to economic prosperity or creditworthiness. Growth prospects are poor and LDC debts have increased both absolutely and in relation to economies or exports.

Slow growth, of course, in the LDC's has brought sluggish trading for the developed countries. The United States has been a major victim. You quoted the statistics, Mr. Chairman. Hundreds

of thousands of U.S. manufacturing jobs have been lost and farm incomes have suffered as well. Now, why the shortfall? Because the current strategy, while constructive, has not adequately met the conditions needed for LDC growth.

For LDC's to recover, two conditions must be met.

First, funds must be available for investment, and that means reversing the net resource transfer from LDC's, that you also quoted. It's massive.

Second, the LDC's must accelerate their adoption of growth-enhancing, market-oriented economic policies.

Both conditions are necessary; neither by itself is sufficient.

Now, geared primarily to maintaining debt service and avoiding the financial crisis, the current approach has not provided adequate debt relief, sufficient new money or incentive that are large enough to encourage broad economic reforms.

According to the World Bank, there was a $16 billion net resource outflow in 1987. Such outflows lead to low investment levels, which, of course, in turn weakens the commitment to policy reform.

Many political leaders of the LDC's recognize the need for market-oriented policies but face great political opposition at home. Recent election results and looming election prospects show that the debt fatigue that you referenced in a number of those countries may undermine those supporting reform and bolster the political power of those interested in debt moratoria. Such a shift in policy would be a step toward economic disaster for the LDC's and present a serious economic financial and foreign policy problem for the United States.

Unfortunately, the outlook isn't getting much better. Without new money, LDC's will not have the resources to maintain even minimum growth while servicing their debts. Without new money, the political willingness to stick to reforms is put at risk. And nobody can answer what is going to happen when interest rates go up or when a recession happens in the developed countries.

THE NEED FOR AN INTERNATIONAL DEBT REORGANIZATION FACILITY

With both economic reforms and reversal of that outflow of resources needed for economic growth, some methods must be found and devised to link these two together. Banks alone cannot do that. But I2D2 or something like that can, because the objective with that sort of mechanism is to create a reinforcing cycle in which debt relief or new credit provide real incentives for sticking to needed economic reforms, and those very reforms lead to new investments.

What are the things that fall in the category of commitments that the LDC's have made? The list is long, but can be summarized that they need to liberalize their economies: by improving the climates for foreign investment and trade; by ceasing to overprotect inefficient domestic industries; by privatizing state enterprises and encouraging increased competition; and by reforming budgets, tax policy and tax systems.

A number of the LDC's have already made good progress, but resistance is strong, and the possibilities of backsliding are ever-

present. More tangible benefits offered by a new facility could provide the incentive for the LDC's to stay the course and, in fact, provide the necessary political appeal to gain even more support at home.

To bridge the gap between the LDCs' need for debt relief and new money and support for sound structural reform programs, the industrial governments must be involved with financial guarantees or contingent commitments. Financial commitments need not be large in terms of out-front outlays. While the original I2D2 proposal called for U.S. investment perhaps as large, if everything happened, as $2.5 billion, both paid-in and callable, we've developed financial alternatives since then that keep the budget outlays relatively small or even zero.

No solution is possible, however, unless governments assume explicitly some of the financial liability which they already implicitly face. I believe the failure of governments to get involved now will only leave them exposed to substantially higher outlays later. The FSLIC experience is a case in point, that is, an example of not tackling problems soon enough with enough. A wise investment strategy for solving LDC debts may, indeed, avoid any future costs. If a plan like this bails out anyone, it is preemptively the FDIC and ultimately the taxpayers.

A MENU OF COMPREHENSIVE APPROACHES

In our initial proposal in February, we suggested a mechanism for reducing the debt service burdens for LDC's. I2D2 would purchase from the banks LDC sovereign debts at a substantial discount. In exchange, it would issue bonds and stock—participating preferred stock—to the banks. The terms of the purchase, including the size of the discount, would be negotiated, country-by-country and voluntarily, with the LDC's. Because of the discount, I2D2's own funding requirements would be much less than the LDC's presently pay to service their outstanding debt. That differential would make it possible for I2D2 to extend significant debt service relief to participating countries, contingent on their acceptance of mutually accepted economic adjustment programs.

I go into much greater detail in my written testimony about I2D2. An LDC debt purchase solution, however, is only one solution, and there are several others out there. A number of inputs have been put on the table and no one option is probably right for all the classes and all the situations. The poor LDC's in Africa and Central America will need debt forgiveness, and the Toronto economic summit reached agreement to provide various forms of relief on bilateral government loans to these countries.

Less poor but troubled LDC's may require substantial debt relief. Those with bright, long-term futures but large debts may need temporary debt service relief, interest rate caps or new loans through credit enhancements.

There are many mechanisms to do this. An international facility purchasing bank loans at a discount is one. Another option is helping the LDC's to convert bank debt to bonds at discounted prices, as the Japanese Government proposed in Canada.

Yet another option is for banks to reduce, for a period of time, LDC interest payments to the levels that they can afford, with banks and industrial governments funding insurance to assure that the reduced interest payments are met.

Not where appropriate, interest payments by LDC's can be capped against rising interest rates with the industrial governments assuming some of the risk. Another approach is through the World Bank, IMF, or the G–7 governments to provide guarantees of bank loans.

Attached to my formal testimony is a matrix of 19 plans that appeared in the July and August issue of "International Economy."

In summary, the necessary pieces are beginning to assemble. Banks have room to be more flexible, since their LDC loan exposure to capital has declined and reserves are higher. The LDC's, of course, are ready. Brazil's return to debt service after last year's moratorium is a sign that LDC's recognize they cannot go it alone. The World Bank and the IMF are exploring new ideas. So is the Inter-American Development Bank. The G–7 countries are beginning to do so. The initiative of the Japanese Government at the summit was especially significant in this regard.

What is needed is a facility to organize, structure and negotiate appropriate packages of debt relief and new credit with economic reforms, country-by-country. A facility to move the LDC's on the road toward sounder policies that increased growth and expands trade, that is what any successful new program must have.

I believe are at an economic and foreign policy crossroads, a crossroad of opportunity. Yes, the time has come for the United States to take the lead in building the next steps to deal effectively with the LDC time bomb. Yes, the time is here for more active U.S. leadership. Thank you.

[The complete prepared statement of James D. Robinson III follows:]

LDC Debt and Trade

Testimony

by James D. Robinson III

Chairman and Chief Executive Officer

American Express Company

Before the

Subcommittee on International Finance and Monetary Policy

Committee on Banking, Housing and Urban Affairs

U.S. Senate

Washington, D.C.

August 2, 1988

Mr. Chairman and Members of the Subcommittee:

I welcome this opportunity to testify on the debts of the less developed countries (LDCs) and their effects on trade, growth, and development. U.S. foreign policy, economic policy, and monetary policy are becoming more closely linked than ever. LDC debt is a serious problem on all three policy agendas.

Yes, The LDC Debt Burden Is a Major Problem ...

For whom?

- Certainly, for many international banks, their managements, and their shareholders.
- Certainly, for many debtor countries, both the very poor countries in Africa and for the seventeen heavily indebted middle-income countries, principally in Latin America.

But that's only part of the list. Here's a broader account of the victims -- the stakeholders -- in LDC debts:

- The people of debtor countries, who are paying the price of austerity, inadequate domestic growth, and no funds for investment.
- Many political leaders of those countries, who are trying to meet their external obligations at the cost of domestic prosperity.
- The companies in industrial countries, who have lost export markets because LDC imports have been sharply curtailed. With this has come the loss of jobs, profits ... and tax revenues for the host governments.
- All of us -- because of the potentially destabilizing impact a crisis can have on the world financial system and on our collective, national security.

We are ten days away from the sixth anniversary of the emergence of the LDC debt crisis. For most of that period, the governments of the

industrial countries have been treating LDC debts primarily as a banking problem -- a problem for the banks and the debtor countries to resolve. Certainly, troubled LDC loans in bank portfolios have been a potential threat to the banking system -- a time bomb. But, more fundamentally, LDC debts are also a trade problem, an economic growth problem, and a geopolitical problem.

As a businessman, I believe greater focus needs to be placed on those broader dimensions as we look for more creative ways to address the LDC debt problem. That's the perspective I had in mind when I offered my proposal in late February for a new approach to LDC debts. The gist of that proposal was the creation of a new international entity, which I called the Institute of International Debt and Development, or I_2D_2 for short. I_2D_2 would be a joint venture between the IMF and the World Bank and would serve as a facility for reorganizing LDC debts, country by country, while negotiating broader conditionality programs for sound economic policy reform. By purchasing LDC sovereign bank loans at a discounted price, it would be able to offer meaningful incentives to LDCs who elect to participate in the program.

I introduced this proposal to move the dialogue forward on the need for new ideas and new approaches to LDC debts. Since then, I am delighted to say, the debate has broadened substantially. More attention has been paid to this issue and more proposals have been offered or reactivated. Your efforts, Mr. Chairman, and the work of this Subcommittee have contributed significantly to the heightened attention given this issue.

The debate has essentially divided into two camps:

- those who think the present approach one day will suffice; and
- those who think the present approach, while important, is not enough.

Clearly, I am in the latter camp.

By participating in and listening to the dialogue over the past several months, I've drawn a few conclusions.

First, the broader dimensions of the LDC debt problem are real and cannot be adequately addressed without much greater involvement of the leading developed country governments -- either directly or through the World Bank and IMF.

Second, there are many valid approaches, and packaging of approaches, for providing significant additional funds for investment in the LDCs to support economic growth -- whether in the form of debt relief, or of credit enhancement in support of new lending. In short, the options are plentiful, if the strategy and political will of both developed and developing country governments are there.

Third, regardless of which option to provide funds for investment is selected, I believe a new entity is needed to act as an international reorganization facility. This could be a new facility, as I suggested, or a new department within the World Bank or the IMF. I favor the former because it emphasizes the broader dimensions of the problem and best allows a new entrepreneurial initiative to be launched.

The Need for New Approaches to LDC Debts

Almost three years ago in Seoul, Korea, Treasury Secretary James Baker announced a program for dealing with the debts of less developed countries (LDCs). The Baker Plan has provided a good framework for dealing with LDC debts. Why? Because of its emphasis on:

- growth instead of austerity;
- case-by-case negotiations;
- the need for new resources for the LDCs; and
- the adoption by LDCs of market-oriented policies.

The Baker Plan, importantly, has bought time, allowing banks to build capital and reserves, while reducing exposure. Servicing of LDC debts has continued, albeit with reschedulings and delays. The LDCs have recovered from recessions, expanded exports, and are showing some growth.

Still, the current strategy so far has only held the line. It has not marshalled adequate resources to restore LDCs to economic prosperity or creditworthiness. Investment -- the seed corn for future growth -- has fallen at an annual rate of 4.8% since 1980. On average, the heavily indebted countries grew only 2.3% in 1987, with per capita growth flat, if not negative. Growth prospects are poor. LDC debts have increased, both absolutely and in relation to the growth in economies or exports.

Slow growth in the LDCs in turn contributes to sluggish trade with the developed countries. From 1981 to 1986, imports of goods and services by the seventeen most heavily indebted countries fell by $72 billion, or almost one third. The U.S. has been a major victim of this situation. Our exports to the LDCs are down by at least $20 billion since 1980, and as much as $60 billion below where they would have been if prior trends had continued. That's 10% to 35% of our trade deficit. Hundreds of thousands of U.S. manufacturing jobs have been lost and farm incomes have suffered as well.

Why the shortfall? Because the current strategy, while constructive, has not adequately met the conditions needed for LDC growth. For LDCs to recover, two conditions must be met:

- First, funds must be available for investment to support growth. That means reversing the net resource transfer from LDCs, which has totaled $96 billion since 1983.
- Second, the LDCs must accelerate their adoption of growth-enhancing, market-oriented economic policies.

Both conditions are necessary; neither by itself is sufficient.

Geared primarily to maintaining debt service and avoiding a financial crisis, the current approach has not provided sufficient new money, adequate debt relief, or incentives substantial enough to encourage economic reforms needed to generate growth and restore access to credit and investment markets.

The current approach despite good intentions has not provided the resources LDCs need for growth and investment. According to the World Bank, net new loan flows (public and private) to the seventeen most indebted LDCs were only $13 billion in 1987, compared to $35 billion in 1982. These were not enough to offset LDC interest payments, leaving a $16 billion net resource transfer or outflow from the LDCs in 1987.

Such outflows lead to low investment levels and poor growth. That in turn weakens the commitment to policy reforms. Many political leaders in the LDCs recognize the need for market-oriented policies, but face political opposition from entrenched local interests. The austerity programs forced on these leaders in the effort to maintain debt service have added an almost insuperable political burden. Recent election results and looming election prospects show that public patience is wearing thin in many LDCs. As a result, "debt fatigue" in a number of countries may undermine those supporting reform and bolster the political power of those interested in debt moratoria. Such a shift in policy would be a step toward economic disaster in the LDCs, and a serious economic, financial, and foreign policy matter for the U.S.

Unfortunately, the outlook is not getting much better. The World Bank estimates that the LDCs need $16-17 billion per year in external financing for growth and debt service. Foreign direct investment and foreign aid may provide $3-5 billion. Loans from the World Bank, the industrial countries, and other public sources may equal $5 billion. That still

leaves $6-9 billion that the LDCs will need each year. With old LDC loans worth 60 cents on the dollar or less in secondary markets, banks are becoming more reluctant to lend such amounts of new money. Without new money LDCs will not have the resources to maintain even minimum growth while still servicing their debts. Without new money, the political willingness to stick to reforms is put at risk. And no one can answer what will happen if interest rates shoot up, or the developed countries slip into a recession.

The Need for An International Debt Reorganization Facility

With both economic reforms and a reversal of the net outflow of resources needed for economic growth in the LDCs, some mechanism must be devised to link these together. Banks alone cannot accomplish that, but I_2D_2 -- or something like it -- can. I_2D_2 was designed to provide the leadership and financial support for developing comprehensive programs by combining debt relief and/or new credit with substantive commitments to market-oriented structural reform. The objective is to create a reinforcing cycle in which debt relief or new credit provides incentives for sticking to needed economic reforms, and those reforms lead to new investment.

What LDCs need for growth is more investment -- both foreign and domestic, including the return of flight capital. Comprehensive market-oriented structural reforms adopted in exchange for meaningful debt relief and new credit are more likely to attract new investment than the current approach.

Developing Country Commitments: To establish credibility and creditworthiness, the LDCs themselves must make major policy reform

commitments. Specifically, LDCs need to liberalize their economies:

- by improving the climate for foreign investments and trade;
- by ceasing to overprotect inefficient domestic industries;
- by privatizing state enterprises and encouraging increased competition; and
- by reducing budget deficits and reforming tax systems.

A number of LDCs have already made good progress. But the resistance is strong and the possibilities of backsliding are considerable, especially when rewards seem distant and unforthcoming. More tangible benefits offered by a new facility could provide the incentives for the LDCs to "stay the course" on the admittedly difficult structural reforms while providing the necessary political appeal at home.

Developed Country Commitments: To bridge the gap between the LDCs' need for debt relief or new money and support for sound structural reform programs, the industrial governments must be involved with financial guarantees or contingent commitments. The financial commitment need not be large in terms of up-front outlays. While the original I_2D_2 proposal called for a U.S. investment perhaps as large as $2.5 billion (both paid-in and callable), we've developed financing alternatives that keep budget outlays relatively small, or even zero. Details on the options for providing support are included in Appendix I attached to the testimony.

No solution is possible, however, unless governments assume explicitly some of the financial liability which they already implicitly face. I believe a failure of governments to get involved now will only leave them exposed to substantially higher outlays later. FSLIC experience shows the cost of not tackling problems soon enough. A wise investment now in resolving the LDC debt problem may, in fact, avoid any future costs.

Such government financial involvement in a solution is not a bank bailout. Banks will take real losses in any of these comprehensive approaches. If these plans bail out anyone, it is, preemptively, the Federal deposit insurance system, and ultimately the taxpayer.

A Menu of Comprehensive Approaches

In our initial proposal in February, we suggested a mechanism for reducing the debt service burden for LDCs. I_2D_2 would purchase from the banks a less developed country's debt at a substantial discount. In exchange, it would issue bonds and participating preferred stock to the banks. The terms of the purchase, including the size of the discount, would be negotiated, country-by-country and voluntarily, with the LDC. Because of the discount, I_2D_2's funding requirements would be much less than the LDC's present debt service requirements. The differential would make it possible for I_2D_2 to extend significant debt service relief to participating LDCs, contingent on their adherence to mutually accepted economic adjustment programs. Details on the mechanism are included in Appendix I and II.

An LDC debt purchase solution, however, is but one of several options. Many comprehensive proposals have been put on the table. No one option is likely to be right for all cases since LDCs vary in their current creditworthiness, debt service capacity, and growth potential. The very poor LDCs in Africa and in Central America will need debt forgiveness. The Toronto Summit established that with the G-7 agreement to provide various forms of relief on bilateral governmental loans. Less poor but troubled LDCs may require sustained debt relief. Those with bright long-term futures, but large debts, may need temporary debt service relief, interest rate caps, and/or new loans through credit enhancement.

There are many mechanisms to do this. I and others have proposed an international facility to purchase banks' LDC loans at a discount. Another option is helping the LDCs to convert bank debt to bonds at discounted prices, as the Japanese government proposed at the Toronto Summit. The final Summit communique indicated that the Japanese proposal would be formally considered by the G-7 finance ministers.

Yet another option is for banks to reduce, for a period of time, LDC interest payments to the levels the LDCs can afford, with banks and industrial governments funding insurance to assure the reduced interest payments. Where appropriate, interest payments by LDCs can be capped against interest rate rises, with the industrial governments assuming some of the risk. Another approach is for the World Bank, IMF, or the G-7 governments to provide guarantees of bank loans and more co-financing to encourage new lending. Still other ideas exist. A matrix of nineteen plans from the July/August issue of International Economy is attached as Appendix IV.

Conclusion

In summary, the necessary pieces are beginning to assemble. Banks have room to be more flexible since their LDC loan exposure relative to capital has declined and reserves are higher. The LDCs are ready and indeed eager. Brazil's return to debt service after last year's moratorium is a sign that LDCs recognize they can't go it alone. The World Bank and IMF are exploring new ideas; so is the Inter-American Development Bank. The G-7 countries are beginning to move. The initiatives of the Japanese government at the Summit were especially significant in this regard.

What is needed is a facility to organize, structure, and negotiate appropriate packages of debt relief and new credit with economic reforms, country-by-country, and make the most of the op rtunity to move the LDCs on the road towards sound policies that increase growth and expand trade. That's what any successful program must have.

Appendix I

The Institute of International Debt and Development

(Description)

Description of Proposal: The central feature of our initial proposal was a market-oriented mechanism set up as a joint venture of the World Bank and the IMF to facilitate the reorganization of LDC sovereign bank debt through the creation of a new entity, called the Institute of International Debt and Development (or I_2D_2). The major developed country governments would provide the initial capital and contingent ongoing support.

Working with the IMF, the World Bank, the Paris Club, etc., the new Institute would negotiate, country by country and voluntarily, the scope of structural economic reforms. The new institute would purchase from the banks a less developed country's sovereign bank debt at a substantial discount. The terms of the purchase, including the size of the discount, would be negotiated, country-by-country and voluntarily, with the LDC. I_2D_2 would hold the purchased loans at their original face value but would grant interest and/or principal concessions to the LDC, thereby capturing the market discount for the benefit of the LDC. Because of the discount, I_2D_2's funding requirements would be much less than present debt service requirements. The differential would make it possible to extend significant debt service relief to participating LDCs, contingent on their adherence to mutually accepted economic adjustment programs and to more open markets.

I_2D_2 could also subordinate the debt it acquired to new debt. New loans would thus have a prior claim on resources, opening the door to new

sources of credit for a developing country. Subordination, like debt relief, would remain in effect as long as the country adheres to its side of the bargain on structural reforms.

Organization: In terms of organization, the facility should be a joint venture of the World Bank and the IMF. In practice, it could well be a part of the IMF or the World Bank. However, there are conceptual and operational reasons why the most attractive arrangement would be to make the facility a joint venture of the two. For example, a joint venture would encourage cooperation between two institutions that both have a role in LDC growth and development. A new facility would also have the advantage of its own mandate, own financing arrangements, and own distinctive powers. The Board of Directors of such a joint venture should include representatives of the sponsoring governments, the IMF, the World Bank, GATT, the participating debtor countries, the creditor financial institutions, and the central banks. The managing director would come from the IMF or World Bank, or be hired by them.

Advantages: Both debt relief and debt subordination would provide the LDCs with greater room for growth, and greater incentives for "staying the course" on the admittedly difficult policies needed to restore economic health and creditworthiness. The banks, while having to absorb the discount, would gain high-quality, government-backed securities in exchange, with reasonable write-off accounting procedures. In return for their capital investment and contingent support for the plan, the developed countries would benefit from stronger growth in the LDCs and better export markets, as well as a more stable financial system. The IMF and World Bank would have new powers that supplement what they can do now.

Size: Because I_2D_2 would be voluntary, its size would depend on the number of countries that agree to structural reform/debt relief packages. If all seventeen countries covered by the Baker Plan agreed to participate, I_2D_2 would acquire at a discount bank loans with a face value of $250 billion.

In fact, I_2D_2 could be much smaller. The concept is modular, although part of its flexibility and strength would derive from a pooling of cash flows from several participating LDC countries. Because I_2D_2 would be implemented voluntarily, some countries may choose not to participate. Or they might not reach mutually acceptable terms with I_2D_2. Or I_2D_2 might decide that a particular country was ineligible, for instance because its actions were those of a "rogue" debtor. In addition, the amount of capital the developed countries are prepared to commit or guarantee may not allow I_2D_2's ultimate size to be that large. The important thing is to start the process. Test it, probably with a smaller country at first. Then, expand it.

The Discount and the LDC: Formally, I_2D_2 would have gained title to loans with full face value, and an LDC would still be expected to service those loans in full unless I_2D_2 agrees otherwise. In practice, I_2D_2 would reduce the debt service burden and postpone, delay, or even forgive repayment of principal. I_2D_2 offers the LDCs the opportunity for interim debt relief in order to restore growth, but judgments made by I_2D_2 allow the degree of ultimate debt servicing to be made with greater flexibility than if the debt remained in the hands of the banks. A country's long-run creditworthiness will be directly influenced by how much of its current debt is ultimately serviced.

Actual discounts offered by I_2D_2 would probably be between the secondary value and objective standards of acceptable debt service burdens. This would allow I_2D_2 to offer banks a premium over secondary market prices, while leaving room for I_2D_2 to meet its own debt service needs in the event of shortfalls in LDC debt service abilities.

The discounts at which I_2D_2 would acquire LDC loans from banks could be as very low or very high, depending on the country. For purposes of illustration, our original proposal assumed that the loans would be acquired at an average price of 60% of face value (a 40% discount). A 40% discount means that I_2D_2 would have to issue $150 billion of securities in exchange for the approximately $250 billion in bank loans to the Baker seventeen if all countries participated.

The Mix of Securities Issued to Banks: The securities issued by I_2D_2 to the banks in exchange for their LDC loans would be a mixture of consols (perpetual bonds) and participating preferred stock. The consols would pay a floating rate tied to LIBOR, but with a cap. Interest on the consols would be paid under all circumstances. The stock would entitle the banks to a share of any debt servicing from the LDCs above and beyond I_2D_2's own debt service and administrative needs, including the maintenance of a reserve fund. Dividends on the preferred stock thus would only be paid if LDC debt service was above the level required to pay interest on the consols and maintain desired reserves.

The basic mix of consols and stock would be a ratio of $10 of consols to $2 of participating preferred. Assuming the full size of the program outlined above, I_2D_2 would issue consols of $125 billion and participating preferred stock of $25 billion.

Developed Country Capital Contributions: In our initial proposal, the major developed country governments were asked to provide the initial capital of I_2D_2, either directly or by call, as well as provide on-going supplemental contingent support. The initial capital would provide a reserve for I_2D_2's own debt servicing needs. The amount of capital proposed was 10% of the consols issued by I_2D_2, or $12.5 billion assuming maximum participation in the program. The G-7 nations would be the most likely sponsors, although other developed countries could also be asked to participate. As with a World Bank General Capital Increase, only a small portion would have to be paid in up-front -- perhaps 10% or $1.25 billion -- with the rest being callable if needed.

The share of the capital each country would be expected to contribute would be set by negotiations. We have assumed the U.S. would have a 20% share (the amount at which veto rights are set). We think, based on discussions with Japanese private and public sector representatives, that Japan would be willing to take an even larger share because of their interest in recycling their savings funds, their desire to play a more substantial role in world financial affairs, and their recognition of the burden-sharing responsibilities of the leading economic powers.

For the U.S., the maximum amount that would have to be put up in initial paid-in capital in our proposal would be $250 million. This amount would be less if the program turned out to be smaller than required for the 17 Baker Plan countries.

Refinements to the Proposal

Since the initial proposal, we have refined the plan in several ways.

The Discount on Bank Debt: First, we've added further detail on the discount at which I_2D_2 would buy LDC loans from the banks. That

discount would vary from country to country depending on several factors, including the secondary market value of the loans and the level of debt that a particular LDC is able to service given current and prospective export earnings. Currently, the secondary market value of LDC loans ranges from about 5% of face for Peru to 60% for Columbia or Chile. These prices occur in a thin market characterized by more sellers than buyers, but nonetheless one that forms a floor. On the other hand, projections of ability to pay for the seventeen countries suggest that discounted loan prices of 30% to 90% (or discounts of 70% to 10%) would be sufficient to bring the ratio of interest payments to exports down to the 20% level generally considered to be the point of minimum creditworthiness. These might be the prices, for example, at which I_2D_2 purchased LDC debt.

Mix of Securities: Second, we've adjusted the package of securities that banks receive in exchange for their LDC loans. The securities issued by I_2D_2 to the banks included a mixture of consols and participating preferred stock. Banks are given stock as well as consols to allow them to share in the upside potential for growth in the LDCs as partial compensation for the loss that banks would take at the outset. Because the participating preferred stock would be specifically for each LDC, banks that believe a particular country can service a higher proportion of the debt than the discounted price could opt for a higher proportion of stock in exchange for a lesser quantity of consols to capture that surplus. Indeed, a bank could obtain a package of I_2D_2 securities that under ideal circumstances would provide the same rate of return as on the initial loan. However, that bank would have a smaller proportion of consols, and thus a smaller guaranteed return under more adverse conditions. I_2D_2 can offer such an arrangement because it reduces the amount of consols that must be serviced.

Alternative Methods for Capitalization by Developed Countries: Third, given the budgetary constraints that exist in the U.S. and elsewhere, we have developed alternative capitalization approaches that avoid up-front government financing of I_2D_2. One alternative would be to set I_2D_2 up as a new window in the IMF. To preserve the credit rating of the IMF and provide a sufficient reserve for the servicing of I_2D_2 debt, IMF member quotas would need to be increased. However, U.S. budgetary practice treats an IMF quota increase as an exchange of assets since an IMF member gains an equal number of SDRs (Special Drawing Rights) from the IMF for any increase in quota contributions. Thus, though budget authority would rise, outlays would not. In effect, the U.S. contribution to I_2D_2 could thus be funded without a direct budgetary impact.

Is the Plan Voluntary for Banks? The plan is voluntary in the sense that a debt purchase agreement could not go into effect unless a majority of banks agree to sell their loans at a discount. It is then admittedly coercive for the remaining banks -- but the reorganization is negotiated and banks do have choices. They can hold the loan if it is marked down to secondary market value. They can sell out in the secondary market. They can take exit bonds. They can accept the standard I_2D_2 package of consols and participating preferred, which guarantees them certain minimum income and additional income under more favorable conditions. They can opt for a mix of securities that offers the possibility of the same return as on the present face value of a loan to an LDC. But they cannot simply hold the loan at par and expect full payment - nor could they in a bankruptcy proceeding.

Appendix II

The Institute of International Debt and Development

(Term Sheet)

Purposes of New Entity:

- To provide the IMF and the World Bank with new options, powers, and incentives in negotiating conditionality programs for LDC economic policies and debt service revision.
- To act as a reorganization entity, on a country by country basis, for LDC debts.

Organization:

A multinational organization (the "Institute") will be formed as part of or as a joint venture of the IMF and World Bank by a number of the large industrialized non-communist countries (the "Sponsoring Governments"). The Institute will acquire, at a substantial discount, all of the sovereign debt of the heavily indebted, less developed countries that elect to participate (the "Participant Countries") from the financial institutions, principally banks (the "Banks"), that currently hold it.

Capital Structure:

Sponsoring Governments will purchase common stock (for cash or the obligation to contribute) and commit to purchase a class of preferred stock (the "Sponsor Preferred") if the Institute is unable to service its debt. For every $1 of common equity capital committed by the Sponsoring Governments, $2 of a second class of preferred stock (the "participating preferred stock") and $10 of debt in the form of consols will be issued to acquire Participant Country debt..

The Board of Directors:

The Board will consist of representatives of the Sponsoring Governments, the World Bank, the IMF, GATT, the Inter-American Development Bank, the Participant Countries, and the Banks. Voting power will be distributed principally to the Sponsoring Governments based on their proportionate equity contributions with certain veto rights for major contributors.

General Manager:

A joint venture of the IMF and the World Bank.

Agreements with Participant Countries:

On a country-by-country basis, the Institute will negotiate agreements regarding each nation's sovereign debt. Each Participant Country will agree to pay for a period of two years or longer sufficient funds to provide the Institute with positive cash flow (i.e., collections that exceed the interest costs of acquiring that country's debt).

Subordination of the Existing Debt of the Participant Countries:

The Institute may agree to subordinate the Participant Country's existing debt to new financing incurred after the existing debt has been acquired. Subordination (the "Subordination Window") will remain in effect unless and until notification of termination by the Institute is given.

Acquisition of a Participant Country's Debt:

The Institute will acquire a Participant Country's debt from the Banks in exchange for consols and participating preferred stock. In general, the consideration for the debt will be mixed so that $1 of participating preferred stock is issued for each $5 in consols. However, a Bank may elect to substitute $2 of participating preferred stock for each $1 of consols to which it otherwise would be entitled.

Consols:

The consols will provide for a floating rate of interest, equal to LIBOR, but subject to a fixed rate cap. Payment of interest will be supported by a reserve fund (initially funded with the equity contributions made by the Sponsoring Governments) and the commitments of the Sponsoring Governments to purchase "sponsor preferred stock". Although there will be no fixed date for repayment of principal, the consols may be redeemed when the reserve equals a certain level.

Participating Preferred:

The participating preferred will entitle the Banks to a share of the Institute's collections of interest from the Participant Countries.

On-Going Operations:	The Institute will: o monitor the economies of the Participant Countries; o enter into periodic renegotiations of the debt in light of then-current circumstances; and o provide incentives for the adoption of market-oriented policies and sanctions for willful failures to pay.
Debt Relief:	While the LDC debt acquired by the Institute will be kept at par, all Participant Countries will be granted debt relief to some extent, which will reduce interest, principal, or both, for specific periods of time. Debt forgiveness may be extended to those Participant Countries that despite good-faith efforts prove unable over time to resume full debt service.
Private Sector Financing:	Private sector financial institutions should be willing to provide additional funds to the Participant Countries, at least on a short-term trade and project finance basis, during the Subordination Window and to participate in co-financing projects with multinational development institutions. Thus, the subordination achieved by the debt reorganization, as well as the improvement in their economies resulting from structural reform, will give these developing countries access to the resources necessary for renewed economic growth.

Appendix III

Alternative Approaches to the LDC Debt Service Burden

The mechanism of buying debt from the banks at a discount is one way to relieve the LDC debt burden for the most heavily burdened LDCs, at minimum long-run cost to the developed countries. Similar ideas have been proposed by academics like Peter Kenen of Princeton, financiers like Felix Rohatyn, and policymakers like Arjun Sengupta of the International Monetary Fund. Congressman Donald Pease has a particularly well-developed proposal with many similarities to and some differences from our proposal.

Many Members of Congress, including the Chairman of this Subcommittee, Senator Bill Bradley, and Congressmen Walter Fauntroy, John LaFalce, Bruce Morrison, David Obey, and Charles Schumer have made noteworthy contributions to the search for new ideas. I will not review these because of your familiarity with your colleagues' proposals. Instead, let me mention some ideas from the private sector that may be new to you.

Interest Payment Reductions with Insurance: One option is a period of interest payment reductions, with some form of insurance that the reduced payments are made. The best-thought-out proposal of this kind, in my view, has been made by C.E.D. Ritchie of the Bank of Nova Scotia. His proposal would reduce for a period of time LDC interest payments to levels the LDCs can afford. To maintain the reduced interest payments in the event of non-economic or external problems, banks would fund the up-front costs of a captive insurance fund, which would be further backed by government guarantees. Finally, the principal of the loans would be securitized by zero-coupon bonds issued by the G-7 countries and bought by

the LDC or in its behalf by the IMF or World Bank. Charles Sanford of Bankers Trust has proposed something like this. The idea is appealing because it allows the banks to keep the loans, yet provides significant debt relief to the LDCs with a minimal role for the industrial country governments.

Interest Payment Caps: A second option is an interest compensation fund to cap interest payments by LDCs if interest rates rise. Alfred Herrhausen and Anthony Solomon, former President of the New York Federal Reserve Bank, have proposed such a plan. It would be used for countries not yet in trouble, but who would be if interest rates go up. This could be a more attractive alternative to the IMF's recently approved "Compensatory Contingency Financing Facility," which lends LDCs funds to cover shortfalls in debt service capacity caused by commodity price declines, natural disasters, or interest rate increases.

Loan Repayment in Local Currency: Another option is to allow LDCs to make debt service payments in local currencies that banks can't repatriate for several years. This has been suggested by Professor Rudiger Dornbusch of the Massachusetts Institute of Technology. Coupled with a requirement that LDCs run a balanced budget, this proposal would reduce the need for LDCs to generate foreign exchange through export earnings. Such a plan was used as an option in Turkey during its debt restructuring in the early 1980s.

Debt Forgiveness: For African countries with a high amount of bilateral debts, reduction of the principal of the loans through forgiveness may be appropriate. The French, German, and Japanese governments at the Toronto

Summit joined the Canadian government in proposing to forgive a portion of bilateral loans to poor African countries. The Summit endorsed these and other approaches for reducing the debt service burden of the poorest countries.

New Credit Enhancement: Another approach has focussed, not on debt relief, but on enhancing new credit flows through World Bank or creditor government guarantees. Yusuke Kashiwagi of the Bank of Tokyo, among others, has called for World Bank guarantees of bank loans and more co-financing to encourage new lending. The Japanese government at the Summit proposed co-financing of bank loans both by the IMF and by its own export bank. Eugene Rotberg, former Treasurer of the World Bank and now at Merrill Lynch, has proposed a more elaborate and far-reaching plan for the World Bank to securitize new bank lending to the LDCs.

Text of Parallel IBRD and IMF Resolutions establishing the Development Committee[1/]

WHEREAS the Committee of the Board of Governors of the International Monetary Fund on Reform of the International Monetary System has recommended the establishment of a joint ministerial committee of the Boards of Governors of the International Monetary Fund (the Fund) and the International Bank for Reconstruction and Development (the Bank) to carry forward the study of the broad question of the transfer of real resources to developing countries and to recommend measures to be adopted in order to implement its conclusions;

WHEREAS it is desirable to consider the question of the transfer of real resources to developing countries in relation to existing or prospective arrangements among countries, including those involving international trade and payments, the flow of capital, investment, and official development assistance;

WHEREAS the said Committee has invited the Managing Director of the Fund to discuss with the President of the Bank the preparation of appropriate parallel draft resolutions on the establishment of such a joint ministerial committee for adoption by the respective Boards of Governors of the Fund and Bank;

WHEREAS pursuant to such discussions the President of the Bank and the Managing Director of the Fund have proposed to the Executive Directors of the Bank and Fund, respectively, and the Executive Directors of the Bank have approved the submission of this Draft Resolution to the Board of Governors of the Bank and the Executive Directors of the Fund have approved the submission of a parallel Draft Resolution to the Board of Governors of the Fund;

WHEREAS the Committee as envisaged would be helpful in providing a focal point in the structure of international economic cooperation for formation of a comprehensive overview of diverse international activities in the development area, for efficient and prompt consideration of development issues, and for coordination of international efforts to deal with problems of financing development; and

WHEREAS the Board of Governors of the Fund is considering the said parallel resolution;

NOW, THEREFORE, the Board of Governors hereby RESOLVES:

1. Establishment and Composition of Joint Ministerial Committee

(a) There is established a Joint Ministerial Committee of the Boards of Governors of the Bank and Fund on the Transfer of Real Resources to Developing Countries (hereinafter called the Development Committee).

(b) The members of the Development Committee shall be governors of the Bank, governors of the Fund, ministers, or others of comparable rank.

(c) The members of the Development Committee shall be appointed in turn for successive periods of two years by the members of the Bank and the members of the Fund. The members of the Bank shall appoint the members of the Committee for the first period of two years, which shall run from the date of the adoption of this Resolution until the date of the regular election of executive directors in 1976.

(d) Each member government of the Bank or the Fund, as the case may be, that appoints an executive director and each group of member governments of the Bank or of the Fund, as the case may be, that elects an executive director shall appoint one member of the Development Committee and up to seven associates, and, for any meeting when the member of the committee is not present, may appoint an alternate with full power to act for the member at such meeting.

(e) Each member and associate shall serve until a new appointment is made by the member government or member governments of the Bank or the Fund, as the case may be, that are entitled to make the appointment or until the next succeeding regular election of executive directors, whichever is earlier.

2. Chairman

The Development Committee shall select a Chairman from among its members, who shall serve for such period as the Committee determines. The Chairman of the Boards of Governors of the Bank and the Fund, or a governor designated by him shall convene the first meeting of the Committee and shall preside over it until the Chairman has been selected.

3. Meetings

(a) Members of the Development Committee, associates, and the executive directors of the Bank and the Fund, or in their absence their alternates, shall be entitled to participate in meetings of the Committee, unless the Committee decides to hold a session restricted to members, the President of the Bank, and the Managing Director of the Fund. Participation in respect of each item on the agenda of a meeting shall be limited to one person in respect of each member government or group of member governments that appoint a member of the Committee.

Appendix IV

Debt Plan Scorecard

PLAN NAME	PRINCIPAL FEATURE	LESS OUT	MORE IN
ALFONSIN	Changes value of obligation; debt increase.	•	• Interest and principal. Commercial banks reduce interest rates on their outstanding debt by four percentage points and reschedule existing credits for 30 years with substantial grace periods. Official creditors also reduce interest rates on their outstanding debt by four percentage points and reschedule amortization payments for 30 years. Public. Official creditors—i.e., World Bank, Inter-American Development Bank, export-credit agencies—provide enough new loans so that disbursements of new loans exceed revised interest payments on old loans.
BAILEY	Changes nature of debt; changes value of debt.	•	Interest. Banks swap existing loans for new Exchange Participation Notes that provide lenders with a pro-rata share of the debtor's annual foreign exchange receipts.
BAKER	Debt increase.		• $20 billion from commercial banks, $9 billion from multilateral lenders.
BANK OF AMERICA	Banker's choice. Either increase debt or change value of existing debt. Weak credit enhancement.	•	Interest. Banks can either charge lower interest rates or increase lending. • Bank loans.
BANK OF NOVA SCOTIA	Changes value of debt; changes nature of debt; credit enhancement.	•	Interest. Debt relief provided by a negotiated reduction of interest payments to all lenders holding existing debt. Interest on trade credits and interbank lines will not be reduced. Amount of negotiated interest reduction will be determined by country's annual export earnings. • Public. New World Bank loans.
BOLIVIA BUYBACK	Changes ownership of debt; changes value of debt.	•	Principal. Country purchases commercial bank loans at secondary market price.
BRADLEY	Changes value of obligation; changes nature of obligation; credit enhancement; pertains only to Guatemala, Honduras, El Salvador and Costa Rica.	•	Interest. Interest rate on official U.S. government loans would be reduced by four percentage points; debtors swap low-interest, long-term securities for their outstanding commercial bank loans; U.S. government guarantees interest and principal payments on these newly issued securities; countries allowed to substantially increase their exports of sugar, molasses and syrups to the U.S.
BRAZIL	Debt increase. Clears all Brazilian interests arrears; officially moratorium.		• New money: $5.2 billion worth of new bank loans, including $750 million co-financing with the World Bank; $2.85 billion in parallel financing with World Bank; $1 billion in new money bonds; $600 million medium-term trade deposit facility. Restructuring: $61 billion of $67 billion of medium-term and long-term bank debt maturing between beginning of 1987 and end of 1993 rescheduled over 20 years with 5-year grace period and interest rate reduction of 90 basis points. Issue of exit bonds totaling $5 billion at fixed interest rate of 6% with 25-year maturity.
CASTRO	Changes nature of debt; credit enhancement.	•	Interest. Debtors cease paying interest. Creditor governments make interest payment instead directly to commercial banks.
DE CARMOY	Debt increase.		• Mostly public. Creditor governments and multilateral development banks make new loans at concessional rates. Private commercial lending limited to project and trade finance.
FIRST INTERSTATE	Credit enhancement; debt increase; changes nature of debt.	•	None. 70% of existing bank loans converted to securities collateralized by U.S. government zero coupon bonds. • Private. Commercial banks lend debtors funds to purchase zero coupon bonds.

CARROTS / STICKS	INSTITUTIONAL INNOVATION	DEBTOR REQUIREMENTS
[illegible] posal voluntarily, the debtors will impose it unilaterally.	None.	Debtors will expand [illegible] programs and adopt structural reforms that are "compatible with short-term macroeconomic equilibrium."
Commercial banks avoid write downs and reduce or avoid additions to loss reserves; payments of principal and interest are automatic.	None.	Compliance with IMF adjustment program.
[illegible]	None.	Compliance with IMF/WB growth-oriented structural-adjustment programs.
Disbursement of new commercial bank loans timed to coincide with disbursement of new World Bank loans, providing commercial banks with weak credit enhancement.	IMF External Contingency Facility.	Debtors agree to forgo some interest rate concessions if commodity prices rise.
Principal repayment of restructured debt will be collateralized by creditor-held zero coupon bonds; interest insurance fund will be established to guarantee payment of reduced interest payments in the event that export earnings fall below a specified level.	Interest insurance fund, located in World Bank, will be capitalized by lenders in proportion to their exposure.	Liberalized equity [illegible] conversions of debt-equity swaps.
Funds for purchase provided by donations from other countries.	IMF hold donations in special escrow account.	Banks cash [illegible]
U.S. government guarantee of rescheduled interest and principal payments.	None.	Adherence to World Bank structural-adjustment policies.
Brazil cheats [illegible] banks collect [illegible]	None.	Bank loans released only in conjunction with IMF adjustment program.
Plan backed by deferred-spending agreement enacted by creditor governments.	None.	None.
[illegible]	New international Action Committee will disburse loans and negotiate structural reforms with debtors.	Compliance with IMF and World Bank adjustment programs.
World Bank guarantees interest payments on commercial bank loans made so that countries can purchase U.S. zero coupon bonds; restructured loans collateralized by U.S. zero coupon bonds.	None.	Compliance with World Bank structural adjustment program.

DEBT PLAN SCORECARD

PLAN NAME	PRINCIPAL FEATURE	LESS OUT	MORE IN	
GARCIA	Changes value of debt; debt increase.	•		Interest. Country limits total interest payments to 10% of export earnings and only pays those creditors making new loans.
KAUFMAN	Changes value of debt; changes nature of debt.	•		Principal. Banks convert portion of LDC portfolio into higher yielding securities. Face value of securities is equal to secondary market price of existing commercial bank loans.
LEVER AND HUME	Credit enhancement; debt increase.		•	Private. New loans from commercial lenders in amounts needed to keep debtor countries current on existing debt.
MEXICAN-MORGAN GUARANTY	Changes value of debt; changes ownership of debt; changes nature of debt; credit enhancement.	•		Principal. Debtor repurchases its commercial bank loans at secondary market prices with securities collateralized by U.S. zero coupon bonds.
MITTERAND	Changes value of obligation; pertains only to official credits previously extended to the poorest countries of Sub-Saharan Africa.	•		Interest or principal. Creditors decide whether they want to: Forgive one third of the debt and reschedule the remainder at current interest rates for 10 years; reschedule the entire debt at commercial rates for 25 years; or reschedule the debts at less than half the market rate of interest for 15 years.
OKITA	Debt increase.		•	Public. A Japanese Trust Fund will borrow funds on the Japanese financial market at commercial rates of interest and relend the proceeds to debtor nations at concessionary rates of interest. The resulting interest subsidy will be financed from part of the expected increase in Japanese official development assistance.
PEASE	Changes ownership of debts; changes value of debt.	•		Principal. Banks sell loans to facility at "underlying value" —defined as the price that reduces debt-service payments to "sustainable" levels compatible with pre-1982 growth rates.
ROBINSON	Changes ownership of debt; changes value of debt; changes nature of debt; credit enhancement; increases country debt.	•		Principal. I2D2 purchases existing loans at secondary market price.
			•	Private. Countries complying with IFM programs will be permitted to negotiate new commercial bank loans.
ROHATYN AND ALTMAN	Changes value of debt; changes ownership of debt.	•		Interest. U.S. banks swap Mexican debt for securities offered by new U.S./Mexican Development Finance Authority that carry lower interest rates.
			•	Direct foreign investment.
ROTBERG	Credit enhancement; debt increase.		•	Private. New commercial bank loans in amounts sufficient to keep debtors up-to-date on existing debt-service obligations. Principal payments rescheduled with a 20-year balloon.
SACHS	Changes nature of debt; changes value of debt.	•		Interest. Interest payments forgiven in countries with acute declines in per-capita income.
			•	Public and Private. New loans from commercial banks and official lenders to less acutely affected debtors linked to specific investment projects.
SENGUPTA	Changes nature of obligation; changes value of obligation; credit enhancement.	•		Interest. Commercial banks exchange a portion of their loans to eligible debtors for low-interest bonds issued by a Debt Adjustment Facility.

CARROTS / STICKS	INSTITUTIONAL INNOVATION	DEBTOR REQUIREMENTS
[illegible] banks new loans or not get paid.	None.	[illegible]
Banks amortize loans over life of loan; banks that carry options for conversion to equity [illegible]	None.	Compliance with IMF/WB adjustment program; debtors offer equity options in securities.
Creditor governments guarantee interest payments on new lending. Non-participating commercial banks forced to write down non-performing loans and reschedule principal.	None.	Compliance with IMF/WB adjustment programs.
Principal (but not interest) of securities [illegible] swapped with U.S. zero coupon bonds.	None.	Sufficiently large reserves of foreign exchange to purchase U.S. zero coupon bonds.
[illegible]	None.	Adherence to IMF and World Bank structural-adjustment policies.
Japanese banks recycle the countries' surpluses without directly increasing their exposure to debtor nations. Principal repayments on loans to Japanese Trust Fund guaranteed by the Trust Fund's holdings of Japanese government zero coupon bonds.	Creation of Japanese Trust Fund.	Compliance with World Bank and IMF structural-adjustment programs.
Cooperating banks are given five years to [illegible] write-downs and are exempted from new capital guidelines. Non-cooperating banks write down LDC loans to secondary market values [illegible] are not exempt from new capital-adequacy guidelines; mandatory sales of loans [illegible] limit their current secondary market [illegible]	IMF facility to purchase commercial loans.	Compliance with conventional IMF adjustment programs that emphasize reduced internal consumption, poverty alleviation and broad-based growth.
G-7 finance guarantees [illegible] and interest payments on 12D2 securities for commercial bank loans will be [illegible] deemed by 12D2. Commercial banks and debtors [illegible] 12D2.	Create new Institute of International Debt and Development (I2D2), possibly affiliated with IMF or World Bank.	Compliance with adjustment program [illegible] ated by I2D2; subordination and unnecessary terms will disappear if adjustments are abandoned.
Nic with [illegible] capital for lending to [illegible] banks. Participating banks must agree to lend [illegible] loss to Finance Authority over five years.	Creation of new U.S./Mexican Development Finance Authority.	Country must agree to privatize nationalized banks and manufacturing industries; removal of barriers to direct foreign investment in [illegible] manufacturing and real estate.
If country cancels about 20-year bullet [illegible] World Bank affiliate will give commercial banks a security with face value equal to discount of outstanding loans and interest rate tied to long-term Treasury bill yield.	World bank affiliate to extend guarantees.	Compliance with IMF/WB adjustment program.
Commercial lenders allowed to amortize write-offs; new loans will be parallel to existing debt.	None.	Compliance with World Bank structural adjustment program.
Interest payments on Facility bonds guaranteed by IMF; principal payments on Facility bonds guaranteed by creditor governments. Participating banks must promise to continue participating in [illegible]	Creation of new Debt Adjustment Facility affiliated with IMF.	Compliance with IMF adjustment programs; facility managers certify that country has reasonable prospects of resuming growth and servicing debt.

COUNTRY-RISK WATCH

	TIME COMPARISON		1988 *PROJECTED* EXTERNAL ECONOMIC INDICATORS							
	Situation Compared To 1 Yr Ago	Outlook For 6 Mos From Now	Projected Trade Balance	Current Account To GDP	External Debt to GDP	Annual Debt-Service To GDP	Reserves Months Of Imports	Total Foreign Debt	Debt To BIS Banks	Debt To U.S. Banks
ARGENTINA			+$2.5b	−4.8%	90%	8%	3	$62b	$33.5b	$8.5b
BOLIVIA			−$167m	−13%	121%	9%	2	4.9b	0.7b	63m
BRAZIL			13.2b	+9%	39.8%	5%	5	122.5b	81.9b	20.5b
CHILE			+$1.6b	−1%	109%	10%	8	21.5b	14b	5.9b
COLOMBIA			+$1.3b	−2%	45%	8%	9	17.7b	6.5b	2b
ECUADOR			+$700m	−5%	110%	12.8%	3	11b	5.4b	1.7b
IVORY COAST			+$1.2b	−4%	75%	9%	0	10.3b	3b	354m
MEXICO			+$8.2b	+2%	80%	9%	12	105.8b	74b	21.2b
MOROCCO			−$1.2b	−1.8%	99%	10%	1	20.7b	3.7b	731m
NIGERIA			+1.3b	−7%	107%	10%	2	31.7b	6.8b	624m
PERU			+$127m	−3.5%	50%	4%	2	18.8b	7.3b	840m
PHILIPPINES			−$850m	−2%	80%	9%	2	30b	15.3b	4.3b
URUGUAY			+$119m	−3%	75%	8%	5	5.8b	2.3b	900m
VENEZUELA			+1.9b	−1%	69%	10%	8	33b	27b	7.9b
YUGOSLAVIA			−$634m	+1.3%	35%	7%	2	22.8b	9.7b	1.8b

GLOBAL DEBT CLIMATE:

Debtors	Worsened
Creditors	Worsened

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EXTERNAL POSITION					DOMESTIC INDICATORS			
Commercial Bank Credit	Official Credit Status	IMF Program Status	Eligible For Ex-Im Credit	Paris Club Reschedg	Date Of Next Election	**Political-Social Index	Exchange-Rate Appropriate?	
[redacted]					Nov 1989	2	Debatable	ARGENTINA
					1989	3	Yes	BOLIVIA
					Nov 1989	2	Yes	BRAZIL
					Sep 1988	3	Yes	CHILE
					1990	2	Yes	COLOMBIA
					August 1988	2	Debatable	ECUADOR
					1990	3	No	IVORY COAST
					Jul 1988	2	Yes	MEXICO
					1990	2	Yes	MOROCCO
					1987-88	2	Yes	NIGERIA
					Apr 1990	1?	No	PERU
					1992	1	Yes	PHILIPPINES
					1989	3	Yes	URUGUAY
					Dec 1988	3	No	VENEZUELA
					May 1988	2	Yes	YUGOSLAVIA

Note: Country-risk watch is compiled by *The International Economy* on the basis of interviews with several country-risk specialists. In some cases, numbers are rounded and may not add up precisely. Some items involve judgment calls. Assessment completed about one month before publication date.

*Private Sector only

**Political-social index
1—Potential for severe political unrest
2—Political situation not conducive to sound economic policies
3—Adequate

(b) The President of the Bank and the Managing Director of the Fund shall be entitled to participate in all meetings of the Development Committee, and each may designate a representative to participate in his place at any meeting when he is not present. Each may be accompanied normally by two members of his staff, at any unrestricted session of the Committee.

(c) The Development Committee shall invite the heads of other international financial or economic organizations, as well as other persons, to attend or participate in meetings of the Committee relating to their areas of responsibility.

4. Terms of Reference

(a) The Development Committee shall maintain an overview of the development process and shall advise and report to the Boards of Governors of the Bank and the Fund on all aspects of the broad question of the transfer of real resources to developing countries, and shall make suggestions for consideration by those concerned regarding the implementation of its conclusions. The Committee shall review, on a continuing basis, the progress made in fulfillment of its suggestions.

(b) The Development Committee shall establish a detailed program of work, taking account of the topics listed in Annex II of the Outline of Reform. The Committee in carrying out its work shall bear in mind the need for coordination with other international bodies.

(c) The Development Committee shall give urgent attention to the problems of (i) the least developed countries and (ii) those developing countries most seriously affected by balance of payments difficulties in the current situation.

5. Procedures

(a) The Development Committee shall meet at the time of the annual meetings of the Boards of Governors of the Bank and the Fund and, in addition, as often as required. The Chairman may call meetings after consulting the members of the Committee and shall consult them on calling a meeting if so requested by any member of the Committee.

(b) A quorum for any meeting of the Development Committee shall be two-thirds of the members of the Committee.

(c) The Development Committee may establish sub-committees or working groups from time to time.

(d) The Committee shall appoint an Executive Secretary, who shall be entitled to participate in all Committee meetings. The Executive Secretary, supported by a small staff as necessary, and drawing on the staffs of the Bank and the Fund to the maximum extent feasible, shall be responsible to the Committee for carrying out the work directed by the Committee.

(e) Appropriate arrangements shall be made for the coordination of the work of the Development Committee and the work of the Executive Directors of the Bank and the Fund.

(f) The President of the Bank and the Managing Director of the Fund shall arrange to carry out technical work requested by the Committee and provide administrative support for the Committee within the competence of their organizations.

(g) The Committee may request assistance from international organizations or other bodies or individuals in connection with the preparation of its work.

(h) In reporting any suggestions or views of the Development Committee, the Chairman shall seek to establish a sense of the meeting. In the event of a failure to reach a unanimous view, all views shall be reported, and the members holding such views shall be identified.

(i) The Development Committee shall report not less than once a year to the Boards of Governors on the progress of its work and may publish such other reports as it deems desirable to carry out its purposes.

(j) The Development Committee may determine any aspect of its procedure that is not established by this Resolution.

6. Administrative Costs

The Bank and the Fund shall make such financial appropriations, in equal proportions, as are necessary for carrying out the work of the Development Committee.

7. Review

At the end of two years from the effective date of this Resolution, the Boards of Governors of the Fund and the Bank shall review the performance of the Committee, and shall take such action as they deem appropriate.

Appendix V
Questions and Answers about
the Institute of International Debt and Development
(I_2D_2)

Background

Q1 Is the present approach to the burden of the debts of less developed countries (LDCs) adequate?

A No. Despite the long sustained global expansion and falling nominal interest rates, the present approach has not:
- o "revived economic growth for LDCs or
- o "restored normal debtor/creditor relations."
(Michel Camdessus, Executive Director, IMF, 3/8/88)

Only success is that a banking crisis has been avoided.

Q2 Why is the present approach not working?

A Not enough new credit for growth in the LDCs at a time of massive capital outflows in debt service: total outflow of $96 billion since 1983).

Q3 Why aren't banks providing enough new credit, as the Baker plan asked?

A Banks are unwilling to lend new money at par when they are carrying old loans at a discount and the market is saying even greater discounts are needed.

- o Banks now only extend new credit as part of debt rescheduling agreements under pressure from the government, the IMF, and other banks. This is hardly a "voluntary" or "market-based" solution.

Q4 Hasn't the current bank-based approach encouraged market-oriented reforms and investment policies in the LDCs?

A Yes, but not very well.

- o Encouragement of LDC market-oriented policies should be the responsibility of the IMF, World Bank, and the developed countries.

- o Banks should not be in the position of "setting government policy" because they are looked to as the source of new funds.

Q5 Is an overall plan desirable?

A An overall plan that treats every country the same isn't. But that is very different from a comprehensive framework that is modular, flexible, and tailors the remedies country-by-country.

- o It's the latter approach that is needed -- and I_2D_2 is designed to do that.

I_2D_2 and the Banks

Q6 Is I_2D_2 a bank bailout?

A No. The I_2D_2 plan is not a bailout of the banks on the backs of the taxpayers.

- o The banks will have to write off the discount on their loans against earnings.

- o They will have a loss to this extent of any inadequacy in their loan loss reserves

- o This is a very real and in some cases very substantial loss that banks and bank shareholders will have to take.

Q7 What about banks that have already decided to reserve against write-offs on LDC loans?

A A discount that is lower than what a bank is already privately prepared to write off would benefit the bank.

But such a benefit is relative. The bank still has to write off the loan to some extent, and take that loss.

Q8 Does this plan hurt the financial system as a whole?

A On the contrary, it will help the banking system as a whole.

- o The financial system is already at risk because of the threat of LDC loan nonaccruals or repudiations.

- o The plan is in many ways a preemptive bailout of the financial system, the Federal deposit insurance system, and ultimately the taxpayer.

- o With I_2D_2, the value of the LDC debt would be smaller, and bank exposure sharply reduced.

- o The real threat to the banking system is inaction in not moving from the Baker Plan to the next phase.

Q9 What benefits do banks derive from the plan?

A Bank losses on the exchange of LDC loans for I_2D_2 securities, while real, are contained and manageable.

- o The danger of further deterioration in the value of loans currently held is avoided since banks receive high-grade, interest-paying securities in exchange for their discounted loans.

- o Because of the improvement in asset quality, banks would be allowed to amortize the loss over several years, with the unamortized portion counting as a reserve in the bank's capital base.

- o Individual banks will have a bigger or smaller loss depending on their level of loan loss reserves.

Q10 Under I_2D_2, the banks have to take an irreversible hit. Is this avoidable?

A No. The banks' LDC loans are already in trouble.

- o Some loans -- those to Peru and Bolivia last year, for example -- have not been serviced at all.
- o Most have been serviced so far, but barely, usually after crisis negotiations, and with stretch-outs and forced new loans.
- o The secondary market -- admittedly thin -- indicates loans are worth much less than face value.
- o Banks have already built up reserves against losses on these loans.

Q11 So far, banks have avoided write-offs or write-downs of LDC loans. Why does I_2D_2 force the issue?

A Because some write-offs are inevitable, and to capture the benefits of such write-offs in terms of potential debt relief for LDCs.

- o The market doesn't believe balance sheets and income statements are accurate reflections of quality of LDC loans.
- o Money center bank stock prices are depressed.
- o I_2D_2 establishes a process for adjusting LDC loan values to the reality of what LDCs can service, one that restores credibility to bank income statements and balance sheets, and avoids a downward spiral in the value of banks assets.
- o Banks have to take a one-time hit, but after that are in a secure financial position, with no further deterioration in asset value since they receive top-grade I_2D_2 securities.

Q12 How can the expectation that banks take a loss be reconciled with their need to build capital, especially given the moves to higher capital adequacy standards both here and abroad?

A More capital is very important for banks in today's world of volatile markets. The increase in capital adequacy standards proposed by the Federal Reserve in response to the Cooke Committee recommendations is a useful step.

- o However, the stock of banks with LDC debts is selling at a discount because of lack of investor confidence, making raising capital difficult.
- o Banks' ability to count general loan-loss reserves as part of capital will be limited by Fed standards, worsening burden on banks.
- o Despite losses under I_2D_2, banks' equity prices would probably improve, because LDC loan problem would be put behind banks, and quality of asset portfolios would be improved.

Q13 Why do all banks have to participate?

A Any plan should require virtual universal participation by banks in order to permit debt subordination and to avoid the "free rider" problem.

Q14 What is the "free rider" problem, and how does I_2D_2 address it?

A Free riders are banks that benefit from any improvement in LDC debt quality without the sacrifices of the program.

- o Banks are offered both the carrot of more lenient treatment of write-offs if they participate, and the stick of either lower-yielding exit bonds or forced marking of loans to market value without the more favorable treatment of write-offs.
- o This combination of rewards and penalties should eliminate the free-rider issue for all banks in participating G-7 countries.

Q15 I_2D_2 basically pushes banks out of the business of sovereign balance-of-payments lending. Why?

A Banks should not be in that business.

- o Government policies and actions can have too many overriding impacts.
- o LDC government policy risks are obvious.
- o But government policies of developed countries, which can not be controlled, also have impacts.
  - For instance, export subsidies of developed countries have depressed many commodity prices, depriving LDCs of vital sources of income.
  - Developed country trade barriers hurt ability of LDCs to export.
  - Mismanagement of developed country fiscal/monetary policies has also negatively impacted LDCs through high interest rates.

I_2D_2 and the Developed Country Governments

Q16 Why do developed country governments need to put up money? Can't this be handled by the banks, or the international institutions?

A The real issue is not whether developed country governments have to put up money to resolve the LDC debt burden, but when they will have to.

- o The governments already have a large contingent liability, due to their financial commitments to the banking system and the international financial institutions.
- o The cost to government may be zero if LDCs fully service their debts, but ultimate cost to government in I_2D_2 would also be zero in that case.

Q17 Other comprehensive plans have avoided the government putting in money up front? Why doesn't I_2D_2 do this?

A Because most alternative approaches increase contingent liabilities even more.

- o If governments decide that they don't want to appropriate money now for a comprehensive solution, there are other ways to set I_2D_2 up.
- o But the governments' contingent liability in the future will go up in these alternatives.

Q18 what are the advantages of upfront government funding as opposed to increased contingent liabilities?

A Better chances of success, less future risk, and greater flexibility.

- o The governments' financial stake in I_2D_2 provides this plan with the flexibility to adapt to new contingencies.
- o In a sense, I_2D_2 is overfunded relative to current needs, because economic conditions could get worse as well as better. The plan is financially strong enough to function in bad times as well as good.
- o Alternative plans that do not require this upfront government investment may well require even larger government financial support in the future.

Q19 How much money would the governments have to put up under I_2D_2?

A Assuming full participation of the seventeen debtor countries targeted by the Baker plan, G-7 governments would buy $12.5 billion of I_2D_2 stock (5% of face value for LDC sovereign bank loans).

- o This amount would be less if the program turned out to be smaller than the 17 Baker Plan countries assumed.

Q20 How much money would be involved for the U.S.?

A For the U.S., the maximum amount that would have to be put up in initial capital in our proposal would be $2.5 billion.

- o Like a World Bank General Capital Increase, most of this amount would be callable; the actual paid-in amount would be, say, 10%, or $250 million.
  - -- Budget authority would be needed for the entire capital commitment.
  - -- Outlays would consist only of the paid-in amount plus any part of the callable portion that the Congressional Budget Office deems likely to be required.

Q21 Are there ways to fund I_2D_2 without outlays from the government?

A Yes. One alternative is to set I_2D_2 as an affiliated institution to the IMF but without a major reserve fund.

- o Back-up support would be provided through a newly created IMF window that would lend funds to an LDC that is unable to meet its debt service payments to I_2D_2.
- o To assure funding without dilution of IMF resources or creditworthiness, a special quota increase from developed countries would be appropriate.
- o The U.S. share of such a quota increase would require an increase in budget authority, but no outlays because the U.S. would receive a matching increase in SDRs.

Q22 What do the U.S. and other developed country governments gain from their financial commitment to I_2D_2?

A The financial participation is really an investment in growth, primarily in the LDCs but also in the developed countries.

- o Because I_2D_2 would have the resources to provide meaningful debt relief to the LDCs and the encouragement of new lending through debt subordination, it provides the two elements that are essential to restore strong growth in the less developed countries.
- o Stronger growth in the developing countries will lead to more exports for the developed countries.
- o More exports will lead to stronger growth, healthier manufacturers, and more jobs for the U.S.

Q28 Does I_2D_2 provide enough debt relief to restore growth in the LDCs?

A Yes, because the discount would be large enough to do so.

- o The goal would be to bring ratios of interest payments to exports down to sustainable levels.
- o As a rule of thumb, discounts would be large enough to bring debt service ratios close to or below the 20% level often considered the maximum acceptable for creditworthy nations.

Q29 How would the discount on an LDC's debts be determined?

A The discount would vary from country to country depending on several factors, including:
-- the level of debt that a particular LDC is able to service given current and prospective export earnings.
-- the secondary market value of the loans; and
-- concessions deemed appropriate.

- o Currently, the secondary market value of LDC loans ranges from about 5% of face for Peru to 60% for Columbia or Chile.
- o These prices occur in thin markets characterized by more sellers than buyers, but nonetheless form a floor.
- o On the other hand, projections for all seventeen countries suggest that discounted loan prices of 30% to 90% of par would bring the ratio of debt service payments to exports for bilateral credits and medium- and long-term bank loans down to the 20% level generally considered the point of deteriorating creditworthiness.

Q30 Doesn't the discount of the price on current LDC loans undermine the creditworthiness of the LDCs and limit their future access to credit markets?

A No more than at present, when low secondary market prices for LDC loans reflect current estimates of LDC creditworthiness and when new lending to LDCs on commercial terms is virtually nonexistent.

Q31 Where will LDCs get new sources of credit, if banks no longer lend?

A Under almost any circumstance, banks are unlikely to make significant new loans to LDCs for a while, nor should banks resume the kind of balance-of-payments lending of the late 1970s and early 1980s.

- o But, banks have been willing to extend short-term trade credit, and are likely to continue to do so.
- o Banks may also be willing to make loans for project finance.
- o Direct investment in LDCs will be an important source of capital.
- o In time, LDCs may raise money through marketable notes and bonds.
- o In any case, increased World Bank and IMF lending will be essential.

I_2D_2 and American Express

Q32 Why is American Express concerned about LDC debts?

A Our concern grows out of our corporate interest in the expansion of world trade and the world economy.

- o Our business does best when the world prospers, because we can sell more travellers' checks, issue more American Express cards, and provide more financial services.
- o LDC debts are hobbling growth in trade and the world economy, especially in less developed countries, but also in developed countries.

Q33 Doesn't American Express have a bank with LDC loans?

A Yes, but we have already acted to reduce our exposure to these loans.

- o Through debt/equity swaps and loan sales, we have reduced our LDC loan portfolio from $2.6 billion to $1.2 billion (as of June 30, 1988).
- o We have boosted loan loss reserves to $744 million, or more than 50% of the remaining loans.

Q34 If I_2D_2 were implemented, would American Express obtain any fees?

A The I_2D_2 scheme has been donated to the public domain. We do not see the prospect of any investment banking fees being generated by I_2D_2. However, if there were opportunities for banking fees, such would normally be open to competition on a world-wide basis.

Senator SARBANES. Thank you very much for an extremely thoughtful statement. We also very much appreciate the appendices which are attached to the statement, in which the proposal is worked out in a great deal of very careful detail.

We have been joined by two of my colleagues, both of whom have a longstanding interest in this subject matter—Senator Graham of Florida, first, who moved right into this issue from literally the first day that he came to the Senate, and who is particularly cognizant of the problems to the south of him in Latin America, and Senator Heinz, who has exercised great leadership in this area over the years as a member of this committee and was formerly the chairman of this subcommittee.

Before I turn to questions, I will turn to Senator Graham and Senator Heinz to see if they have any opening statements or comments.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. Thank you, Mr. Chairman. I apologize for my late arrival. I would like to submit for the record an opening statement. In this statement, I suggest what I think are some of the principles that we need to be focusing on as we kind of weave ourselves through this difficult quagmire.

The first is that there is not a homogeneous Latin America or a homogeneous lesser developed nations debt problem. There is a Venezuelan problem; there is a Brazilian problem; there is a Costa Rican problem. Each has its own special national characteristics and must be dealt with as such.

Second, the debt issue is a political and economic issue and, therefore, must have political and economic solutions apply.

We should also encourage, to the maximum degree possible, commonality and parity of treatment of Third World debt by all industrial nations. I am concerned that a difference in treatment is being accorded today between European banks and United States banks, placing our banks in an increasing disadvantageous position and, frankly, eroding a reservoir of long time good will between the United States and those nations.

I think next that old debt should be handled differently from new debt. Up to the present, new debt has been used in too many instances to pay the interest on old debt, a theme which is unfortunately reminiscent of what we heard this morning, relative to the circumstance in our American thrift industry.

Finally, Mr. Chairman, we need to learn all we can from this experience of the last few years, so that we are not doomed to its repetition, and I would like to submit with my statement an article from "The Economist" of July 30, the headline of which is "East European Debt—So Have We Learnt Our Lesson." Eastern Europe is sinking in debt so deep, it threatens to become the Latin America of the 1990's. What are we doing to apply our last decade's lessons in order to avoid the next decade's problems?

I submit that for the record.

Senator SARBANES. The article will be included along with the statement in the record.

[The complete prepared statement of Senator Graham follows:]

OPENING STATEMENT

SENATOR BOB GRAHAM

AUGUST 2, 1988

MR. CHAIRMAN, LET ME COMMEND YOU FOR HOLDING THESE HEARINGS ON THE INTERNATIONAL DEBT PROBLEMS. THESE HEARINGS ARE EXTREMELY TIMELY IN THAT THE U.S. HAS FAILED TO FACE UP TO THE SERIOUSNESS OF THE LATIN DEBT CRISIS AND HAS INSTEAD TREATED THIS ISSUE WITH A PASSIVE MUDDLING-THROUGH APPROACH WHICH HAS ONLY ADDED TO THE PROBLEM.

THE IMPACT OF THIS FAILURE ON THE U.S. HAS CONTRIBUTED TO PLACING OUR MONEY CENTER BANKS AT RISK; ERODING THE U.S. TRADING POSITION WITH OUR LATIN AMERICAN NEIGHBORS; CONTRIBUTING TO OUR INTERNAL TRADE DEFICIT AND IMPEDING THE DOLLARS OUR EXPORTERS NEED FOR EXPORT FINANCING.

THIS EROSION OF OUR TRADING POSITION HAS CONTRIBUTED TO OUR INTERNAL TRADE AND BUDGET DEFICITS. IT ADDS ANOTHER CORROSIVE

ELEMENT TO AN ALREADY GROWING PROBLEM. THAT IS WHY THE U.S. MUST FIND EFFECTIVE LEADERSHIP ON THE DEBT PROBLEM AND NOT IMPEDE OR FRUSTRATE THE EFFORTS OF THOSE INDIVIDUALS AND COUNTRIES TRYING TO ARRIVE AT A SOLUTION.

THE IMPACT OF OUR LEADERSHIP FAILURE AFFECTS THE LATIN COUNTRIES ADVERSELY AS WELL. THE ECONOMIC ENVIRONMENT DRIVES THEIR STANDARD OF LIVING DOWN. POLITICALLY, WE NEGATIVELY IMPACT MANY OF THEIR FLEDGLING DEMOCRACIES. LONG TERM INTERNATIONAL RELATIONSHIPS ARE STRAINED AND WE GIVE EUROPE, JAPAN AND EVEN THE SOVIET UNION AN OPPORTUNITY TO INCREASE THEIR INFLUENCE IN THESE COUNTRIES BECAUSE OF OUR INABILITY TO TAKE ACTION.

WE SHOULD ADDRESS THE FOLLOWING PRINCIPLES:

- THE DEBT ISSUE IS NOT A LATIN AMERICAN DEBT PROBLEM. IT IS A VENEZUELAN PROBLEM AND A BRAZILIAN PROBLEM. EACH SOLUTION SHOULD BE ON A COUNTRY BY COUNTRY BASIS BECAUSE THEIR DEBT PROBLEMS HAVE BEEN ASSUMED IN DIFFERENT ECONOMIC SITUATIONS.
- THE DEBT ISSUE IS A POLITICAL AND ECONOMIC ISSUE AND THEREFORE WE SHOULD USE POLITICAL AND ECONOMIC SOLUTIONS.

MR. CHAIRMAN, LET ME INCLUDE A QUOTATION FROM AN UNUSUAL SOURCE, ADMIRAL CARLISLE A. TROST, OF THE USN, WHO RECENTLY DELIVERED A PAPER ON LATING AMERICA AND DISCUSSED THE ECONOMIC IMPACTS ON OUR NATIONAL SECURITY AND DRUG TAFFICKING. ADMIRAL TROST FROM A MILITARY PERSPECTIVE SAYS, "IN A FLOURISHING SOCIETY WHERE ECONOMIC OPPORTUNITY AWAITS ALL CITIZENS, WHERE THE HORIZONS OF HOPE ARE LIMITED ONLY BY AMBITION, NONE OFTHE THREATS SO ENDEMIC NOW TO LATIN AMERICA WOULD HAVE A CHANCE TO GET STARTED. ULTIMATELY, THE SOLUTION TO UPHEAVAL ON THIS CONTINENT LIES IN DEVELOPMENT. SOME DAY THE 'HAVES' MUST HELP THE 'HAVE NOTS' EXPLORE THEIR VAST RIVERINE SYSTEMS, BUILD THE DAMS AND HYDRO-ELECTRIC PROJECTS, IMPROVE THE COMMUNICATIONS, CLEAR THE FARMLAND, MAKE THE IMPLEMENTS, MINE THE MINERALS, GROW THE FOOD, AND LIV ETHE LIVES THE GOD INTENDED ALL OF US TO LIVE. UNTIL THAT HAPPENS, OTHER MEASURES CAN ONLY PALLIATE THE PROBLEMS."

- WE SHOULD ENCOURAGE THE MAXIMUM DEGREE OF COMMONALITY AND PARITY OF TREATMENT FOR LATIN DEBT BY INDUSTRIAL NATIONS. FOR EXAMPLE, IT IS TIME OUR ADMINISTRATION WAS AGGRESSIVE AND PRAGMATIC IN WORKING WITH LATIN AMERICAN NATIONS, AND WITH

INTERNATIONAL ORGANIZATIONS SUCH AS THE WORLD BANK, TO SEEK A RESOLUTION TO THE DEBT CRISIS AND TO BE ABLE TO ADDRESS SUCH ISSUES AT THE 1989 ECONOMIC SUMMIT.

- OLD DEBT SHOULD BE HANDLED DIFFERENTLY THAN NEW DEBT. UP TO THE PRESENT, THE NEW DEBT HAS BEEN USED TO PAY THE INTEREST ON OLD DEBT. WE SHOULD RE-EXAMINE THIS CONCEPT AND TREAT THEM DIFFERENTLY.

THESE HEARINGS ARE AN OPPORTUNITY FOR US TO STUDY THE LATIN DEBT ISSUES AND SEE WHAT WE CAN LEARN FROM THEM. THEREBY REDUCING THE PROSPECTS THAT IN THE FUTURE WE WILL HAVE TO REVISIT WHAT BROUGHT THE U.S. INTO ITS CURRENT CIRCUMSTANCES. I LOOK FORWARD TO HEARINGS FROM ALL THE WITNESSES DURING OUR TWO DAYS OF HEARINGS.

East European debt

So have we learnt our lesson?

Eastern Europe is sinking in debt. So deep that it threatens to become the Latin America of the 1990s

IN THE past couple of years some western commercial banks, which had been lending like crazy to some East European countries, have begun to have second thoughts. They needed to. Some communist countries' foreign-currency reserves are falling alarmingly, just when they are likely to be needed. Debt servicing is taking an ever-higher proportion of hard-currency export earnings in countries like Bulgaria and Hungary, just as some of their current-account deficits are beginning to appear long-term problems.

Already Hungary has muttered a muddled and probably unserious threat about rescheduling. Other countries, such as East Germany, are laying in stores of reserves in case bankers start to black Comecon borrowers. Romania is going for self-sufficiency, amid austere cuts that could lead to popular revolt. But Poland, Hungary, Bulgaria and Czechoslovakia would all like to attract foreign capitalists.

The price for new foreign investment has changed. As Latin America is now learning, the world's moneymen are increasingly wary of straight loans, and prefer equity investment or participation in potentially profitable sorts of joint ventures.

Hungary, Eastern Europe's biggest borrower, is experimenting hardest with economic liberalisation. It has signed joint-venture agreements with General Motors and Levi Strauss jeans; these allow the companies to build and own factories in the country. Poland and non-Comecon Yugoslavia—trying to reschedule debt—are mulling over Latin-American-style debt-conversion schemes to subsidise foreign investment. Both are afraid of a lending strike by the western banks.

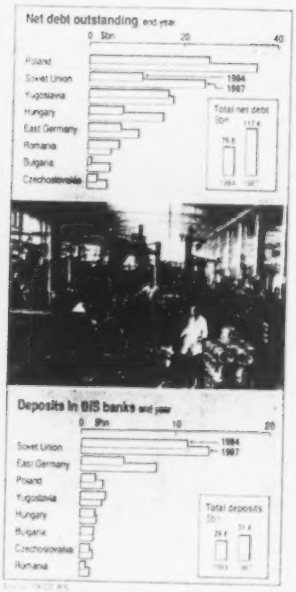
East European net debt (ie, borrowing minus redeposits with banks) is rising fast. It jumped from $70 billion in 1985 to $99 billion at the end of 1987. This is still only just over a third of the debt of Latin America's big three: Brazil, Mexico and Argentina owe $280 billion. But the banks never intended to have even one-third of a Latin problem again.

The fall of the dollar over the past two years has hurt many East European debtors. A large part of Eastern Europe's debt is in currencies such as the D-mark and the yen which have strengthened against the dollar, and too many communist countries thought that holding foreign exchange meant holding depreciating dollars. East Germany was wisest. It invested its reserves in D-marks and other West European currencies.

The Bank for International Settlements estimates that 58% of the $4.4 billion increase (to $9 billion) in East Germany's reserves over the past three years came from the exchange-rate gains. Other countries came unstuck. Hungary borrowed in yen and D-marks and invested in dollars, with dire results to its reserves-to-debt ratio.

Despite these mistakes, Eastern Europe still pays little for its foreign money. Little comfort there; so did Mexico until just before it announced in 1982 that it could not service its debts.

Czechoslovakia is one of the banks' favourite East European borrowers and is allowed to borrow at the cheapest rates. On a recent bank loan it paid only ⅛th of one percent over LIBOR, the banks' wholesale interest rate. The spread over LIBOR is supposed to reflect risk. On that basis, banks judge Czechoslovak loans as only one-fifth as risky as Greek ones. Thanks to such



cheap money, Czechoslovakia's net debt has risen by 50% in the past two years. Alarmingly, while its debt has been rising, Czechoslovakia's economic performance has been deteriorating. Its implicit policy seems to be to use outdated machinery to produce shoddy goods for export to countries in the developing world which do not pay proper hard currency for them. It wants to make these exports less shoddy, and to invest heavily in new factories. That could cost cost $20 billion-30 billion—or five times its existing debt. It will be weird if western banks are willing to lend this.

Two years ago, the banks rated **Hungary** almost as high as Czechoslovakia because (*a*) it has liberal domestic policies and (*b*) it appeared to be a prudent borrower. Now it has a Grecian rating, and should probably have one even lower. It has so far kept up to date with interest and principal payments to its foreign banks, despite teetering on the edge of default.

Over the past 18 months, Hungary has started to run down its reserves to cover its current-account deficits. It will have to pay around $3.5 billion to its foreign creditors this year; $2.5 billion will be in principal repayments and $1 billion in interest, most of which has to be borrowed from banks and multilateral lending institutions. Meeting this year's principal and interest payments on its $18 billion bank debt will take 70% of Hungary's hard currency export earnings. **Bulgaria**'s problems are similar, although they are not yet compounded by Hungarian-style interest and capital repayments. Last year Bulgaria increased its foreign debt by 30%. Simultaneously, its reserves fell by 30%. Its hard-currency current-account deficit totalled $1.3 billion—if the paper surplus with third-world countries is ignored.

Romania, Poland and Yugoslavia are in an intractable mess. **Romania** is, bizarrely, paying off its debt while building up its reserves. This policy should encourage banks to lend but does not. The banks do not trust President Nicolae Ceausescu's economic policies which produced a record hard-currency trade surplus last year of $2.8 billion—but also food shortages, power cuts and political unrest.

Yugoslavia should have few external financial problems. It runs a surplus on its hard-currency current account and pays its debts more or less on time. But it is rescheduling, largely because the government cannot reform the chaotic domestic economy. Many Yugoslavian businesses do not repatriate all export earnings, which exacerbates a shortage of foreign exchange.

Poland built up so much debt in the late 1970s that it cannot service it, and is now building up its reserves by paying less than a third of the interest it should pay. This might conserve reserves but it starves the economy of new investment. Like Brazil, Poland got virtually no cheap export credits from western governments last year.

Bankers' wariness about Eastern Europe shows in their new choosiness about the loans they now make. Several banks have switched away from general-purpose loans to government-sponsored export credits which fund projects such as new steel mills or petrochemical plants.

Japanese banks and bond investors, which have increased loans to East European countries, might turn out to be a friend in need. Japanese banks increased their loans to Hungary sixfold in the period from the end of 1984 until the end of September 1987. The Hungarians expect this trend to continue. The Japanese now seem to prefer Eastern Europe to Latin America as a market for their exports of capital goods. One way of selling heavy industrial kit to Eastern Europe is to lend it money first, though you might think it was worth asking if the money was likely to be repaid.

Bolshoi borrower

RUSSIA is Eastern Europe's biggest and most favoured debtor. Earlier this year it even managed to return to the bond markets after an absence of almost 75 years. The Soviet Bank for Foreign Economic Affairs borrowed SwFr100m ($74m) through a public bond issue—its first such issue since the 1917 revolution. Then, on July 26th, it made its debut in the D-mark bond market. It launched a DM500m ($270m) issue and paid less for its money than the West German government. Although both deals were blocked by some banks which thought that old Czarist debts should be settled, most lenders were reassured by Russia's record as a cautious and reliable borrower.

Russia's deals over the past 18 months have been done mainly with individual banks. This year Russia has to pay off loans of $4.5 billion, the same as in 1987. Like many borrowers it wants to roll them over—ie, pay them back and then immediately borrow the same money at a similar interest rate for a similar period. It will probably have to cover a widening trade deficit in 1988, unless oil prices recover; but bankers expect Russia to increase its net debt by less than $1 billion during the year.

When the terms of trade turn against Russia, the country usually battens down the hatches. After the oil price fell in 1986, Russia sharply cut its imports, sold more gold and stepped up its borrowing. A similarly austere policy in 1987—plus a higher oil price—produced a small trade surplus with the West. Rather than take risks with its credit rating, Russia prefers to cut its foreign imports rather than to borrow more. This policy also prevents it from tempting western imports away inefficiently.

At the end of March 1985, Russia's foreign-exchange reserves were down to $8.7 billion; by the end of 1987 they were up to $14.1 billion. The Russians have long realised the value of keeping deposits with western banks. They have therefore tried to roll over their gross foreign borrowing, and even increase it.

At the end of 1987 commercial banks had lent Russia $33 billion dollars, over twice the amount they had lent at the end of 1984. The rise in bank borrowing helped to make up for a fall in trade credits for specific projects. At the end of 1984, Russia's $25 billion foreign debt was divided almost equally between bank debt and trade credit. The latest figures, for the middle of 1987, show that bank lending now accounts for almost 69% of Russia's debt.

Senator SARBANES. I might note that Senator Dixon was here earlier but had to go to the floor, but his statement and also Senator Shelby's will be included in the record.

[The prepared statements of Senators Dixon and Shelby follow:]

Q23 What impact will I_2D_2 have on tax revenues?

A Probably more plusses than minuses.

- o The losses that banks may have to post on LDC loans would reduce bank tax liabilities, and thus reduce tax revenues.
- o However, this would occur under any circumstances in which banks write off loans.
- o On the other hand, the positive effects of the proposal in terms of higher U.S. trade, better profits and more employment means higher tax revenues.
- o If I_2D_2 leads to enough growth in Latin America for U.S. manufacturers to recover just the value of exports lost since 1981, the Federal government could gain enough new revenues to pay for its investment in I_2D_2 in three years.

I_2D_2 and the Less Developed Countries

Q24 Does I_2D_2 pose a risk that LDCs will suspend current debt service or abandon adjustment programs in order to drive down the value of its debt and increase the size of its discount?

A No, because I_2D_2 would not have to negotiate a debt purchase package with a "rogue" debtor, nor purchase the debt at the artificially depressed secondary market price.

- o LDCs need both debt relief and new credit.
- o Any action that tries to maximize the former will greatly diminish prospects for the latter.
- o An LDC that drives down the worth of its debt would likely find itself with no credit, even for trade, and certainly no debt relief from I_2D_2.

Q25 What are the incentives for a debtor country to stick to structural adjustment under I_2D_2?

A I_2D_2's powers to grant concessionary terms on debt service and give new loans priority over old are very attractive incentives for LDCs to stay the course on economic reforms.

Q26 Does I_2D_2 pass the discount at which it acquires LDC loans from banks directly to the LDCs?

A Not automatically or permanently.

- o I_2D_2 would hold the acquired debt at face value, granting repayment concessions as needed.
- o I_2D_2 would initially require only enough debt service from an LDC to pay the interest on its consols, in order to give the LDC enough debt relief to resume growth.
- o Over the longer run, however, many LDCs will be able with appropriate policies to grow enough and earn enough to service higher levels of debt. Banks will share in this through their holdings of I_2D_2's participating preferred stock.

Q27 Does I_2D_2 forgive the debt?

A Generally no, but in some cases yes.

- o Debt forgiveness may be provided as an incentive to an LDC that sticks to an agreed-upon program of structural adjustments and reforms.
- o Some low-income LDCs may never be able to service much more than this debt level, so some proportion of the debt would be forgiven.

AUGUST 2, 1988

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE HEARING
ON
THIRD WORLD DEBT ISSUES

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS AFTERNOON AS THE SUBCOMMITTEE CONSIDERS INTERNATIONAL DEBT ISSUES. WE HAVE A DISTINGUISHED GROUP OF WITNESSES BEFORE US TODAY, AND I LOOK FORWARD TO HEARING FROM THEM.

AT THE OUTSET, I WOULD LIKE TO MAKE ONLY ONE POINT: THE DEBT CRISIS IS NO LONGER A U.S. BANKING SYSTEM CRISIS. TROUBLED THIRD WORLD DEBT HELD BY U.S. BANKS IS STEADILY DECREASING, AND U.S. BANKS CAPITAL AND LOAN LOSS RESERVES ARE STEADILY INCREASING. THE SIMPLE PASSAGE OF TIME WILL, THEREFORE, "SOLVE" THE DEBT CRISIS, IF WE ARE ONLY CONCERNED ABOUT ITS IMPACT ON THE SAFETY AND SOUNDNESS OF OUR BANKING SYSTEM. IT SEEMS TO ME, HOWEVER,

THAT WE HAVE A NUMBER OF OTHER CONCERNS, IN THE AREAS OF NATIONAL SECURITY, FOREIGN POLICY, AND TRADE, WHERE THE PROGNOSIS IS NOWHERE NEAR SO BRIGHT. I THEREFORE WANT TO TAKE THIS OPPORTUNITY TO CONGRATULATE THE CHAIRMAN FOR CALLING THESE HEARINGS. HE HAS BEEN A REAL LEADER ON THE DEBT ISSUE, AND I LOOK FORWARD TO CONTINUING TO WORK WITH HIM AS WE CONSIDER THOSE ASPECTS OF THE DEBT PROBLEM THAT TIME MAY NOT SOLVE.

Richard Shelby

STATEMENT BY SENATOR RICHARD SHELBY
ON THE INTERNATIONAL DEBT PROBLEM
AT THE INTERNATIONAL FINANCE AND MONETARY
POLICY SUBCOMMITTEE HEARING
AUGUST 2, 1988

MR. CHAIRMAN, I AM GLAD THAT YOU HAVE SCHEDULED THESE HEARINGS. INTERNATIONAL DEBT IS AN IMPORTANT ISSUE; INDEED, IT HAS BEEN OUR FOREMOST CONCERN OVER THE BANKING INDUSTRY'S STRENGTH. THE LDC DEBT CRISIS HAS ONLY RECENTLY BEEN OVERSHADOWED IN THE NEWS BY THAT OTHER DARK CLOUD OVER THE FINANCIAL LANDSCAPE, THE THRIFT CRISIS. THIS COMMITTEE HAS HAD A BANNER DAY, DISCUSSING THE THRIFT INDUSTRY'S PROBLEMS THIS MORNING AND INTERNATIONAL DEBT THIS AFTERNOON.

GLOBALLY, INTERNATIONAL DEBT IS A BIGGER PROBLEM. THE LEAST DEVELOPED COUNTRIES OWE OUR BANKS $100 BILLION DOLLARS. WHILE SOME PROGRESS HAS BEEN MADE IN INSTITUTING ECONOMIC REFORMS IN THE LESSER DEVELOPED COUNTRIES: CURRENT ACCOUNT AND TRADE DEFICITS HAVE BECOME SMALLER, DEBT SERVICE RATIOS HAVE BEEN REDUCED, AND IN SOME CASES, PUBLIC SECTOR DEFICITS HAVE BEEN CUT, THE DEBTOR NATIONS STILL HAVE A LONG WAY TO GO.

OUR FIRST WITNESS, A LEADER IN THE DISCUSSION OVER THIRD WORLD DEBT, WARNS US OF "DEBT FATIGUE." MEASURES OF ECONOMIC AUSTERITY ARE POLITICALLY UNPOPULAR AND CITIZENS OF THESE

COUNTRIES ARE BEGINNING TO CLAMOR FOR RELIEF. YET ALL PRESCRIPTIONS FOR A SOLUTION INCLUDE CONTINUED AID TO DEBTOR NATIONS, TO INCREASE INVESTMENT AND THUS STIMULATE GROWTH. THUS THE ANTIDOTE FOR THAT WHICH HAS PLAGUED OUR BANKS, IS CONTINUED EXPOSURE TO THE RISKS OF THIRD WORLD LENDING, THAT IS, CONTINUED LENDING.

I AM INTERESTED IN ALL PLANS TO CURE OUR BANKS OF THIS SICKNESS. HOWEVER, GENTLEMEN, I WANT TO ENSURE THAT OUR ANTIDOTE IS A VACCINE. CONTINUED INJECTIONS OF CAPITAL SHOULD PROVIDE FOR FUTURE PROSPERITY IN THE LESSER DEVELOPED COUNTRIES AND MAKE THEM CAPABLE OF SERVICING THEIR DEBT. IT SHOULD NOT MERELY INCREASE THEIR DEBT LOAD AND THE BURDEN ON OUR BANKS.

SOLUTIONS TO THIS PROBLEM ARE DIFFICULT AND I ADMIRE THE WORK THAT OUR WITNESSES HAVE DONE. I LOOK FORWARD TO THEIR TESTIMONY.

THANK YOU, MR. CHAIRMAN.

Senator SARBANES. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I would like to commend you for holding these hearings. Certainly we all would like to find a better solution to the LDC debt problem, or crisis as it intermittently becomes, than we have today. We have reviewed quite a procession of plans, solutions, ideas, approaches, and it's easy to become impatient about our inability to find some broader solution. Maybe there is a grander solution to be gotten, I do not know for certain. But I certainly intend to review each of these solutions very carefully and very critically, to be sure that in trading in some of the frustrations of the moment for the prospects of something bigger, simpler, easier, that we don't make a mistake we will regret.

I would observe that reducing debt service is not an end in itself but a means to promote economic recovery. A workable plan, if there is one, must promote country-specific economic reform, not just lower debt service. A debt plan cannot be a gimmick. Regulators and accountants will require risks and losses to be fully reflected on the books, and they should. A debt reduction plan must make sense for all the parties. Regulators can and should provide incentives for resolution of the debt problem, but they can't force banks to forgive loans. Banks can't become philanthropists and give money away. They have to look after the best interests of their shareholders. And creditors must continue to bear the risk of LDC loans. Risks and costs should not be shifted, in my judgment, to U.S. taxpayers, even if the budget would bear it and currently it obviously can't. That transfer, if we permitted it, would reduce incentives for debtors and creditors to solve the problem.

I commend our first witness Jim Robinson for working very hard on a plan that he and I have discussed, corresponded on and will have further discussion on. All of these plans deserve our careful attention and our careful scrutiny, to see if they can and do measure up to these kinds of standards.

I don't suggest they are the only standards, but they are ones that I care about.

I ask unanimous consent, Mr. Chairman, that my full statement be in the record.

Senator SARBANES. Without objection, so ordered.

[The complete prepared statement of Senator Heinz follows:]

STATEMENT OF SENATOR HEINZ

Mr. Chairman, we are approaching the sixth anniversary of the LDC debt problem. When Mexico announced that it could no longer meet its debt service obligations in 1982, the financial system and the countries of Latin America seemed on the brink of financial collapse. Six years later, crisis has given way to chronic illness -- the banks are financially stronger but still heavily burdened with LDC debt; the debtors lurch from crisis to crisis, unable to restore consistent economic growth.

After six years of emergency financing packages, debt plans, and "muddling through," a growing chorus of voices argues that that traditional approaches do not work. Refinancing, new money packages, the Baker Plan, debt swaps must give way to grander solutions -- a multilateral debt facility, debt write-offs by banks, shifting of risk to the IMF, World Bank or developed country governments.

I share the frustration with the current situation that has led to calls for bolder solutions. I would like our banks to put the debt problem behind them and get on with meeting the new competitive challenges and capital requirements of the 1990s. I would like to see renewed growth of U.S. exports to once important LDC markets. I would like to see renewed growth and greater human welfare in the poor, struggling democracies of Latin America. But wishing it will not make it so.

Mr. Rotberg is exactly right when he says there is "no quick fix through financial engineering." The debt problem and its

underlying economic conditions have not been quickly or easily resolved because there is no easy solution to them. As we review various debt proposals, especially debt reduction plans, in our hearings, I believe we must review each very critically in light of the constraints that make this problem so difficult to resolve.

* Reducing debt service is not an end in itself but a means to promote economic recovery. A workable plan must promote country-specific economic reform, not just lower debt service.

* A debt plan cannot be a gimmick; regulators and accountants will require risks and losses to be fully reflected on the books.

* A debt reduction plan must make sense for all parties. Regulators can and should provide incentives for resolution of the debt problem, but they cannot force banks to forgive loans. Banks cannot become philanthropists and give money away; they must look to the the best interests of their shareholders.

* Creditors must continue to bear the risk of LDC loans. Risks and costs should not be shifted to U.S. taxpayers, even if the budget would bear it, because this would reduce incentives for debtors and creditors to solve the problem.

Any plan that measures up to these requirements should be on the bargaining table. And more options and approaches will have to be on the table as the next Administration takes up the challenge of dealing with the debt problem. I look forward to continuing the search for solutions in these hearings.

Senator SARBANES. There is a vote that is going to occur shortly. I am prepared to defer to any of my colleagues who, in leaving to vote, might not be able to come back and continue the hearing because of the press of their schedule. If there is someone who finds himself in that position, I will defer on my own questioning and let him move ahead right now.

[No response.]

Senator SARBANES. Mr. Robinson, let me just follow along then with your statement and put some questions to you.

First of all, I'm interested in the proposal of the joint venture between the IMF and the World Bank. I guess I have two questions.

How complicated would that be to set up, if we moved down that path?

And second, and perhaps more importantly, what consequences do you see it having for those institutions under the rules which they already exercise in the international economic and financial system?

JOINT VENTURE BETWEEN THE IMF AND THE WORLD BANK

Mr. ROBINSON. I think it can be a very exciting and constructive role, because these are the major institutions that must be a major part of any long-term solution. The reason I suggested the joint venture was that this is such a new concept that we are trying to introduce. It is more than a banking problem. It does take on geopolitical and economic and trade dimensions. That requires a dramatic shift in culture, sense of urgency, and focus. And I find in my own organization, such as when we introduced the Optima card, that it is useful to set up kind of a SWAT team like that to make that kind of difference. That is the reason I suggested the joint venture and was careful to say that it would draw most of its staff from the people in those two institutions who, in fact, in many instances could serve in two capacities.

Now, how hard is it to set up?

Some of the research we have done shows that in 1974 there was an excellent step taken in setting up a development committee of those two institutions which was charged with getting them to work together. In fact, when I was reading the description of the development committee initially, I thought that my associates had drafted enabling legislation to put this in right now, because it could almost be a carbon copy of what is needed.

Second, if you approach this from the standpoint of a trust fund, you don't involved in all of the issues of voting power, voting rights, and approvals that take on lives of their own, such as some of the difficulties we have had with MIGA [Multilateral Investment Guarantee Authority]. The only approvals you need in establishing a special purpose trust fund is, first, that of the country that is either giving the money or providing the guarantee, and the second is the enabling vote to allow this to happen.

I think that those precedents, in fact, will give you the opportunity to be very quick in establishing something like this, which, in turn, could then be tried in a couple of countries. Because I agree with you completely, Senator Graham, no two are alike, each has unique needs and unique interests. There is no such thing as a

comprehensive generalized plan. But there should be a comprehensive focus, in terms of packaging for any one selected country.

Senator SARBANES. I am interested in the problem of the so-called "free ride" in any of these approaches. As I have sort of tried to work through this issue, I keep constantly coming up against that. In other words, there's some bank, and it's a voluntary act, I appreciate that, sell their debt at a discount to this facility, not discount it and then pass it on to the debtor country, thereby improving its financial position and enabling it to move back toward the path of growth and strengthening its economy and responding to the needs of the people.

That appears at least to benefit the banks which do not participate in the approach, in other words, who have not taken the discount. They have made no contribution to this strengthening of the position of the debtor country and yet they will reap the benefit.

I would like to hear your analysis of that problem, the free rider problem.

Mr. ROBINSON. The free rider problem is an issue. When we first introduced I2D2, the thinking was how frustrating that there is no international bankruptcy facility. In the United States, when there is a bankruptcy, creditors don't voluntarily turn in their paper at 100 cents on the dollar and take back 40 cents or 70 cents. It's part of a legal procedure that does not exist at the international level. So our focus was to try to create something that could duplicate that mechanism. But as we thought about it more, we decided that, while those powers should be implicit, the approach should be that of a reorganizatioin facility that first tried to gain general consensus among the banks. After reaching a general consensus, then you come up with a package which itself is complete. So, you don't leave free riders simply in place who could benefit, as you just described. Banks have to do something—sell than loans or take exit bonds or write-offs. But they do so after a major consensus has been reacher first.

Senator SARBANES. My time is up. Senator Shelby.

Senator SHELBY. Mr. Robinson, you are very familiar with the Brazilian situation and the strategies they have used.

Do you believe Brazil's experience will serve as an adequate disincentive to other debtor nations not to try the same strategy, or should we be concerned about possible similar defaults?

Could you comment on that?

BRAZILIAN EXPERIENCE

Mr. ROBINSON. I think, as I mentioned in my opening remarks, that one thing that Brazil coming back to agreement has shown is that they realized they cannot go it alone. So that is a plus.

Senator SHELBY. Is that word really out in the international trading arena?

Mr. ROBINSON. I am sure that it is.

Senator SHELBY. It ought to be.

Mr. ROBINSON. This is an eleventh-hour kind of game where everyone will try what they think they need to try. So I do not believe that the question is, have we seen the last of a moratorium? No, I do not believe that will be the case.

These are difficult situations, and the prospects of borrowing more money, putting debt on debt simply to pay old debt, interest on old debt sooner or later wears thin. That is why I think now is the time for really taking advantage of the opportunity that Brazil has given us and to go in and try to package some new solutions that take place before you have a disaster.

Senator SHELBY. Let me see if I understand the basis of your plan.

In effect, would the governments of the lender nations bail out the banks, although at a discount, and would assume or bear the risk of collecting from the debtor nations in the future?

Is that a correct summary of your proposal?

Mr. ROBINSON. That is the beginning of the summary. They buy the debt at a discount. The banks and the shareholders take a major hit by selling the loans at a discount.

Senator SHELBY. They buy it at a discount, but then that also recoups some of the banks' losses, in a sense, although not totally?

Mr. ROBINSON. Some of the German banks will take a hit, which touched on the issue of accounting standards not being similar. Incidentally, if you have not seen, the Overseas Development Council's analysis of that, comparing standards country by country, I will be glad to submit that for the record.

Senator SHELBY. I would like to see that.

[Information follows:]

1988, No. 1

POLICY FOCUS

Banking Regulation and Debt: A Policy of Flexible Response

- Banks have entered a new era of flexible response to the debt crisis. Having strengthened their capital bases and reserves, they are now contemplating innovative approaches that sometimes involve taking losses on Third World loans.
- Increased regulatory flexibility could stimulate bank interest in new options for debt restructuring, such as interest capitalization and debt/security swaps.
- Creditor-country governments can foster bank cooperation and facilitate a negotiated solution to the Third World debt crisis by coordinating their tax, accounting, and supervisory policies.
- Many smaller banks want to exit from Third World lending regardless of accounting and tax considerations. Regulatory revisions will thus be most relevant for large banks with an interest in continuing their financial ties to the Third World.

Since the debt crisis erupted in 1982, banks around the world have bolstered their loan loss reserves and capital and are increasingly equipped to survive losses in their Third World loan portfolios (Figure 1). Developments in international banking during 1987--notably the expansion of loan loss reserves by commercial banks and Morgan Guaranty's plan for a Mexican debt/security swap--further suggest that banks do not believe that most debtors are regaining creditworthiness.

The international financial system is now more stable, but bank balance sheets are still heavily laden with risky developing-country credits. Policymakers in creditor countries hope

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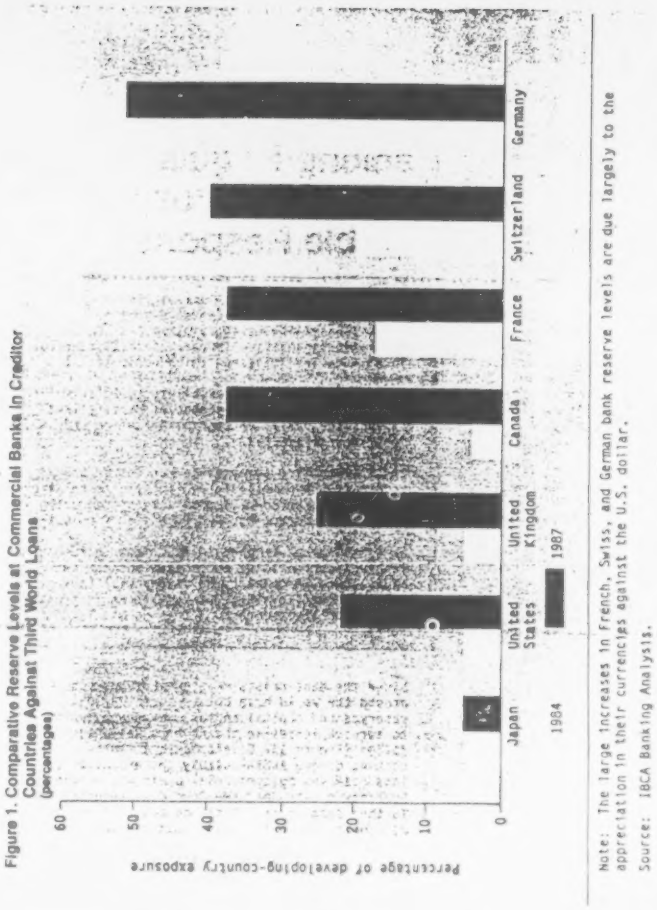
Figure 1. Comparative Reserve Levels at Commercial Banks in Creditor Countries Against Third World Loans (percentages)



Note: The large increases in French, Swiss, and German bank reserve levels are due largely to the appreciation in their currencies against the U.S. dollar.

Source: IBCA Banking Analysis.

to promote further improvements in bank safety while tackling the equally important goal of assisting sustained economic recovery in the debtor nations.

Banks and borrowers are therefore seeking new strategies. Creditor-country governments--in particular, the United States, Japan, the United Kingdom, the Federal Republic of Germany, Switzerland, France, and Canada, whose banks have the highest exposure to troubled debtors (Table 1)--can help to design and implement new solutions.

One powerful tool available to these governments for breaking the Third World debt gridlock is banking regulation. Regulation includes prudential rules and supervision, accounting standards, and tax policies--all of which are shaped by governments. Banks pay close attention to these regulations in managing their Third World loans. Creditor countries should coordinate their regulatory policies, within their own systems and internationally, to speed international cooperation to resolve the debt crisis.

Comparing National Regulations

The most powerful regulations for affecting bank strategies regarding Third World loans are the following:

Capital Requirements

Minimum capital requirements are set by regulators such as the U.S. Federal Reserve Board as a percentage of banks' loans and other exposure (i.e., the risk ratio). Banking systems that permit relatively low capital ratios give their countries' banks a competitive advantage by making lending cheaper.

In December 1987 the "Cooke Committee"--a group of bank supervisors appointed by their governments to advise on coordinating banking regulation among the major creditor-country governments[1]--proposed a uniform international standard for bank capital in their countries. This proposal is expected to be implemented in close to its present form by 1993 and will create more consistent global banking standards.

The new rules will require many banks to raise additional capital, especially those in the United States, France, and Japan. The higher capital standards could complicate debt management, particularly in the United States where banks may be less willing to take losses due to reluctance to draw down loan loss reserves, which are counted as capital.

Loan Loss Reserve Guidelines for Country Risk

Banks can earmark loan loss reserves to apply to specific loans to developing countries, or they can hold general reserves against potential losses anywhere in their portfolios. Some governments--including the United Kingdom and the United States--effectively require specific reserves against loans, or reduced loan valuations, for certain debtors that have exhibited serious repayment difficulties. Other countries--such as Canada and Switzerland--mandate that banks hold reserves against loans to a "basket" of troubled debtor countries.

Requirements for banks to hold specific or basket reserves vary from country to country. U.S. banks must reserve against at least 10 per cent of exposed risk for loans to eight "value-impaired"[2] countries with especially poor repayment prospects. Under Swiss rules, banks must reserve against 35 per cent of all exposure to a basket of more than 80 troubled debtors. Japan has adopted a completely different approach by decreeing a maximum for bank reserves: Its banks can reserve against no more than 10 per cent of their loans to 38 problem countries. This limit restricts Japanese banks' ability to make public the degree to which they are protected against the risk of new lending to troubled debtors.

[1]The Cooke Committee is comprised of policymakers who monitor and regulate measures of financial soundness. Countries that have representatives on this committee are Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

[2]Eight countries are currently classified as "value-impaired": Bolivia, Costa Rica, Liberia, Nicaragua, Peru, Poland, Sudan, and Zaire.

Table 1. Exposure of Major Creditor Countries' Banks to Latin America, 1986

	Canada	France	Germany	Japan	Switzerland	United Kingdom	United States
				($ billions)			
Exposure to major Latin American debtor countries[a]	16,619	20,600	18,083	29,730	6,490	28,999	83,131
				(percentages)			
Percentage of total bank debt outstanding to Latin America	7	9	8	12	3	12	34

[a]Countries included are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela.

Source: IBCA Banking Analysis.

A crucial issue is whether loan loss reserves should count as capital. The Cooke Committee harmonization plan seeks to resolve this question by specifying that by 1993 loan loss reserves should normally constitute no more than 15.6 per cent of minimum capital, if they are included at all. (Most creditor countries do not permit this.) U.S. and French banks will be the most likely to use this provision. Major U.S. banks now rely heavily on reserves to meet minimum capital requirements. These banks are unlikely to meet the new standards in 1992 without counting some loan loss reserves (Table 2). The same is true for the major French banks, which are either state-owned or recently privatized and have very low capital levels but substantial loan loss reserves.

U.S. and European reserve regulations send different signals to banks regarding their new loans to troubled debtors. German and Swiss rules discourage new lending by requiring banks to reserve against all new exposure to problem debtors. As a result, these banks often prefer to let a debtor miss a few payments rather than rushing to make a new loan. In contrast, U.S. regulations require specific reserves only for a few "value-impaired" debtors who have fallen 180 days behind in debt payments and are not close to agreeing on a rescheduling program with their creditors. Therefore, U.S. banks have vigorously promoted new loan packages to help debtors stay within that 180-day limit.

Disclosure Requirements

Public disclosure rules for banks differ dramatically in the major creditor countries. German, Swiss, and Japanese banks can hold hidden reserves (i.e., undervalued assets or overstated liabilities), permitting them to smooth out their reported profits and losses and to

Mr. ROBINSON. The thought on that is this: for instance, let's for a moment assume that all $250 billion in debts of the 17 rescheduling countries was included, although the likelihood of that is very small.

Senator SHELBY. That is a worst case scenario?

Mr. ROBINSON. Well, the worst case/best case. I2D2 buys it all in some respects, about $250 billion. If it is assumed that there is a 40-percent discount, or a 60-percent market value, then you are servicing on $150 billion instead of $250 billion. That doesn't begin to take in the refinements, such as the use of participating preferred stock, which would even lower the debt service further.

So, if the United States because of the FDIC is already in effect standing behind this credit, it is standing behind $250 billion right now. Under my plan that exposure would be reduced down to $150 billion. The cash flows that you would get from the countries themselves, especially if this works in jump-starting their economies, will be more than adequate to service that debt.

Senator SHELBY. So what we have here is not only a financial crisis, we have a political crisis, do we not, Mr. Robinson?

Mr. ROBINSON. Political, and a trade problem.

Senator SHELBY. It is all interrelated?

Mr. ROBINSON. Very much so.

Senator SHELBY. How do you feel about the institute's ability to collect from the Third World countries, the LDC countries? That would be very important to the bonds that you are talking about?

Mr. ROBINSON. The institute should have every bit as much capacity to collect as the present banking structure has because it would have on its board a mix of banks, representatives of the international institutions, the governments, et cetera. It would grant incentives which it can remove if performance is not there. It would still keep the original principal—the amount outstanding—intact unless, depending on the country's situation, and depending on performance achievements, some form of debt forgiveness is ultimately involved. It would have all of the structure, all of the capacity, and I believe more than banks presently have because there is a unified approach.

Senator SHELBY. You don't believe in the long run this is throwing good money after bad because you believe the economies will be stimulated with the trade and be able to earn money to pay that debt off?

Mr. ROBINSON. That is correct. In fact, if you don't start those economies and allow them to show growth domestically as well as being participants in the international trading system, then I think you have a very unstable situation that could ultimately be a serious national security issue as well.

Senator SHELBY. My time has expired.

Senator SARBANES. I bring to the attention of the members of the subcommittee that there is a roll call vote on the passage of the Fair Housing Act. It has now begun. I would suggest that we recess and return, although if a member——

Senator HEINZ. Mr. Chairman, I would be willing to ask questions for a few minutes and then recess the committee if you and the other members would like to go.

Senator SARBANES. We will do that and Senator Heinz will proceed as long as he feels that he can before he has to depart, recess the committee, and we will be back as promptly as we can.

Senator HEINZ [presiding]. Jim, let me ask regarding your proposal, I2D2, what has been the response of the major commercial banks to it? Do they support the mechanism? Do they see the need?

RESPONSE TO I2D2

Mr. ROBINSON. They haven't embraced the exact financials of it, and they disagreed with the preemptive, the quasi-preemptive, effect it would have on forcing them out. Because of that, we have changed the proposal and have allowed greater options in terms of the kind of paper that a particular bank would elect to take. If it believed the future was going to be terrific and one day all the problems would go away, it would take a lower portion of bonds and a higher portion of participating stock.

Some banks, many banks are saying yes, something like this needs to be done. Whether the technique for raising the money is that or not, there would be no disagreement. But we are working closely with the Bank of Nova Scotia and with some other major banks to come up with a joint proposal that would be able to get broad support.

But as I said in my testimony, I think there is a broad number of ways to finance. What is important is to embrace the concept that you need a facility that brings the debtor countries, the banks, and the developed countries together with the international institutions. In other words, somebody has to call the huddle.

Senator HEINZ. One other element of it that I worry about a little bit, which seems to create, if you will, some very flexible accounting rules, is the treatment of loan losses on loans sold as a reserve. That, as I understand it, would permit loan loss recognition over some 10 years.

How would that work, and wouldn't those changes really mask risks and costs that the banks are finally fortifying themselves to deal with?

Mr. ROBINSON. I am very much in agreement with your comment earlier that you don't want any gimmicky in accounting. To simply do that alone would be a mistake.

But bear in mind that I2D2 would not book a transaction until it had agreement from the debtor countries as well as from the majority of the banks. Once that happened, then presumably it is an investment that you are making in a new direction for that country. You are giving them the latitude of debt relief and new credit as part of a package, which in turn is meaningful enough and can begin to attract capital and can be supported further by ODA [Official Development Assistance], such as now is coming out of Japan.

In that kind of scenario, no, I don't think some transition that is primarily designed to allow the banking system to embrace and support this is out of line.

Senator HEINZ. Now, future bank lending would be voluntary under your plan, as I understand it. An old debt would be subordinated, and there wouldn't be any enforcement mechanism as now to keep banks in.

Have I got that right?

Mr. ROBINSON. Yes. In our plan we use the technique of subordination. That was a chapter taken out of the domestic bankruptcy approach to things. Once you have subordinated money, then new money pours in because you have got a substantially different credit. That is how you would get the voluntary money under that approach.

Senator HEINZ. Would banks continue to lend under those circumstances, and if so, to what extent and why?

Mr. ROBINSON. Some would, some wouldn't. My guess is that if you put together a package like this for a particular country, you may have some banks who say "I am out," and others say "I am staying." But I can assure you, whether it is the German banks, the Swiss banks, or the Japanese, in that kind of environment they are going to be going in and it won't be long before the competitive enthusiasm picks up.

If the program negotiated on structural reform is not adequate, then you won't have new money going in.

There is no new money going in now that is voluntary. By and large, it is all under the gun.

Senator HEINZ. Those five bells mean I have less than 10 minutes to get over to the floor and vote.

In accordance with Senator Sarbanes' instructions, I am going to recess the committee until the return of the Chair, and we can all take a little time off until then.

[Recess.]

Senator SARBANES. The subcommittee will resume. I am pleased to recognize Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. I wish to commend you for holding what I believe will be a significant set of hearings on this important national and international issue and that we started with such a thoughtful American student of this issue as Mr. Robinson underscores the importance which you have placed on these hearings.

Mr. Robinson, could you share with us what you think the consequences would be of continuing for the next 36 or 48 months the policy that we have followed in the last 36 to 48 months relative to LDC debt—"we" meaning the United States of America?

CONSEQUENCES OF CONTINUING ON THE SAME PATH

Mr. ROBINSON. I think one could project a disaster scenario where interest rates go back up because of a mass of issues and the Fed tightens money. Then you would have a serious issue on your hands in some of the LDC's, which could lead to new moratoriums on payment of their interest and principal. Mostly now more and more it is becoming interest.

Forty-eight months from now you may well be just where we are now. Debts really haven't gone down, and interest rates may have gone up. The debt/service ratio may be worse than now, but we haven't been done in.

But I prefer to look at it in the context of the opportunity costs of that approach. You have not taken some initiatives that could substantially change the way those countries conduct themselves in

the international trading arena, and you have not reversed the outflow of capital which they dearly need for investment.

Because of that they are underperforming and incurring more and more risk of political crisis back home. And we are underperforming because the markets of an important part of the world are not available for us to sell products to. I think that is almost the most serious issue.

In other words, while initially I started with the focus of how to put a safety net here, and while I think safety nets are part of it, the question really should be how can you get the trading markets of the world active again? If you do it right, the acceleration of free market economies will pick up.

There are some interesting trends going on right now. You have got Russia. You have got China. You have got countries around the world moving away from central planning to market-oriented economies. As a businessman thinking about the time to advertise and invest, it is right now, because the trend lines are very much in the direction of privatization, all the kinds of things that we believe in.

Senator GRAHAM. What are some lessons that you think we have learned from the experience of the last 5 or 10 years attempting to deal with this issue that might be applicable to public policy and private financial sector action?

Mr. ROBINSON. I think certainly the thought that it is impossible for a sovereign government not to pay its debts will no longer be assumed to be a truism. So we have learned that lesson.

If you go back during that historical period of time, the issue of the 1970's was, how do you get the private system to recycle the petrodollars. Banks did that, but they overdid it because they had the view that sovereign governments could not renege. The countries overdid it because they were being sold the loans, in effect.

All of that took place in an environment which I think was less practical. Remember, I said in my remarks there are two conditions that are necessary. One is new investment, regardless of how they get it, and two is structural reform, and one without the other is not adequate. The LDC's didn't have both.

Senator GRAHAM. What is the difference in the way in which European and Japanese commercial institutions or governments treat this issue as opposed to the United States, and what do you think are some of the likely outcomes of that difference of treatment?

Mr. ROBINSON. The Europeans—let me take the German example. They have very heavy reserves, and those reserves were established and were tax-effected reserves. So in fact at this stage, with 50 percent plus reserves and already having taken the tax benefits on that, they would in effect show capital gains if there was a large sale of their bank loans into some central debt purchasing entity.

The Canadian banks are tax effected. The U.S. banks are not, and the Japanese banks are not. The Japanese have low reserves, basically on the order of 5 to 10 percent, but they have also got immense unrealized profits.

So it is not exactly a comparable comparison. But this is one of the anomalies of the system, the great variety of tax and accounting treatment country by country, and it does complicate these issues.

Senator GRAHAM. Are there any differences in treatment in Europe, Canada, and Japan that you think we should look at as a means of creating a more receptive environment for our commercial institutions to take certain steps to follow?

Mr. ROBINSON. This would be somewhat self-serving to say, but tax effected reserves in these particular situations would clearly make a difference.

I realize the difficult political aspect of accomplishing that.

One thing about I2D2, as it was proposed, is it would accelerate banks to an immediate event, an actual sale of loans, and therefore that would trigger a tax deduction. So for those who say "don't accelerate anything because that is going to impact revenues," that would be one reason not to follow the debt purchase facility. Simply setting reserves doesn't impact taxes, but when you realize a loss, that does.

Again, that gets back to the political will. Who is going to take the leadership in this? What solution has the cheapest cost to the government and to the banks while allowing the greatest benefit reasonable for the developing countries?

That should be the focus.

Senator GRAHAM. You discuss the economic impacts beyond those directly related to the financial institutions involved on the general economy, particularly trade.

How much confidence do you have in the analysis that had been done as to the adverse effects on U.S. trade which are a function of the economic problems of the major debtor countries?

Mr. ROBINSON. While there may be some margin of estimating error, you can certainly compute the reduction of some $73 billion over a 5-year period in terms of trade with the LDC's according to World Bank figures. That is the reduction in their imports. Then you have to calculate how much of that came out of our hide as opposed to somebody else's. But as far as Latin America is concerned, those add to the loss of U.S. exports.

So I think it is a very real, meaningful, and extensive impact. We are in communication with a number of associations—soybeans, almond growers, et cetera—and they would agree very much that this is a trade problem; it is not just a banking problem.

Senator GRAHAM. I would be interested if, as you gather more detail on that dimension of the problem, if you could share that with the committee.

My personal sense is that that has been underappreciated and an underincluded aspect of this overall problem.

Mr. ROBINSON. We will certainly do that, and I have figures today that I can leave with you from various published sources.

[The information follows:]

Chairman's Office
American Express Company
September 12, 1988

Table A provides a summary of the trading patterns of the seventeen highly indebted less developed countries (LDCs)* with the United States, other industrial countries, and the world. Tables 1 through 8 provide details on each of these categories of international trade flows.

The data in the tables are based on the International Monetary Fund's Directions of Trade 1988 Yearbook, which was published in late July 1988. The IMF data on inter-country trade only cover exports and imports of merchandise goods, so Tables 1 through 8 reflect only exports and imports of goods, not services. Table A also includes summary data for total exports and imports of goods and services for the seventeen highly indebted countries. Services exports from the LDCs are largely tourism. Services imports to the LDCs are largely interest payments on debts, but also include various professional, business, and financial services.

Table 1 shows the exports to and imports from the United States for the seventeen highly indebted LDCs. Between 1981 and 1986, LDC imports of U.S. products (U.S. exports) fell by $14.7 billion. However, there was a $7.5 increase in LDC imports from the U.S. in 1987, cutting the 1981-1987 decline to $7.2 billion. The improvement in U.S. exports to the LDCs was concentrated in Mexico (up $6.3 billion), and reversed the loss of U.S. exports to Mexico between 1981 and 1986.

LDC exports to the U.S. (U.S. imports) meanwhile showed an even larger increase in 1987, rising by $13.3 billion. Through 1986, LDC exports to the U.S. had actually fallen. Among LDC exports to the U.S. in the 1981-86 period, there were declines in petroleum exports, a small rise in non-fuel commodity exports, and a large gain for manufactured good exports. The decline in petroleum exports largely reflects the drop in oil prices after 1985. The 1987 surge in LDC exports to the U.S. was concentrated in oil (Nigeria, Venezuela, Mexico) and to a lesser degree manufactured goods (Mexico, Brazil). The U.S. trade deficit with the debtor LDCs reached $15.1 billion in 1987, up from $9.3 billion in 1986 and a $3.7 billion trade surplus in 1981 (Table A).

Table 2 shows the LDC trade position with the industrial countries (U.S., Japan, Europe, Canada, Australia, and New Zealand), with Table 4 providing the LDC trade position for the industrial countries excluding the U.S. Driven by the surge in LDC exports to the U.S., LDC exports to the industrial countries reversed in 1987 the decline that had occurred between 1981 and 1986. As a comparison of Table 1 and Table 4 shows, the U.S. remained the primary market for LDC exports, with the U.S. in 1987 absorbing $45.8 billion of LDC exports compared to $42.6 billion for the rest of the industrial world. Indeed, the 1987 figure for the non-U.S. industrial world is still lower than the $44.5 billion of LDC exports they absorbed in 1981.

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* Argentina, Bolivia, Brazil, Chile, Columbia, Costa Rica, Ecuador, Ivory Coast, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia.

On the other hand, the U.S. has made more progress than the other industrial countries in expanding exports to the LDCs. Imports of the LDCs from the industrial countries in 1987 were still $23.2 billion lower than in 1981. Excluding the U.S., industrial country exports to the LDCs (imports to the LDCs) declined from $57.1 billion in 1981 to $41.1 billion in 1987.

The improvement in LDC trade with the industrial countries was largely confined to Mexico and Brazil. Excluding these two countries, the LDCs were still exporting less to the industrial countries in 1987 than in 1981, and imports from industrial countries were $22.2 billion lower than in 1981. Since export earnings are critical to the ability of LDCs to service their existing debts, the declines in or only small increases of exports from the great majority of the LDCs represent a threat to future debt service by these countries.

Table 3 shows the overall trade position of these LDCs with the whole world, including each other. The overall picture remains the same as in Tables 1 and Tables 2. LDC exports overall have recovered some of the ground lost since 1981, especially in 1987, but are still weak outside Mexico and Brazil. LDC imports despite improvement in 1987 are still well below 1981.

Table 5 shows that trade among LDCs has been particularly damaged. Exports of these seventeen LDCs to the non-industrial world fell from $49.2 billion in 1981 to $32 billion in 1986 and then rose to $34 billion in 1987. Their imports from the non-industrial world dropped from $46.4 billion in 1981 to $27.3 billion in 1986 before rising slightly to $30.3 billion in 1987.

Tables 6, 7, and 8 show the trade positions of the LDCs with Europe, Japan, and Canada, respectively.

The loss of exports by the European Economic Community to the LDCs (Table 6) is larger than that by the U.S. (Table 1) in both the 1981-86 and the 1981-87 periods, though in both cases there was a recovery in 1987. However, the EEC's $9.9 billion drop in exports from 1981 to 1987 was primarily due to Nigeria (down $8.4 billion). LDC exports to the EEC dropped by $5.6 billion between 1981 and 1986, but rebounded by $4.1 billion last year. LDC exports to the EEC are still below the 1981 level. The EEC had a $3.8 billion trade deficit with the debtor LDCs in 1987, down from a $5 billion deficit in 1986 (Table A).

Japan's trade with the most heavily indebted LDCs (Table 7) has been smaller than either the U.S.'s or the EEC's, but on the export side suffered proportionately more with less recovery in 1987. The $4.6 billion decline in Japanese exports to the LDCs between 1981 and 1987 represented 41% of the 1981 level, compared to the 19% drop for the U.S. and the 26% fall for the EEC. Similarly, the 24% rise in Japanese exports to the LDCs

pay stable dividends. They can therefore manage their Third World loan portfolios with less concern for stockholder or public opinion.

U.S. banks must disclose all reserves and losses, and also the total of loans that are 90 days past due. Details of debt restructurings and their impact on future lending and repayment must also be published. While these regulations impose market discipline on U.S. banks, they can, perversely, discourage prudence. U.S. banks hesitated to follow the European lead in boosting loan loss reserves partly because they feared adverse market reactions to bad news.

Accounting Standards

Accounting rules instruct bank accountants and auditors on how to value assets and judge the adequacy of loan loss reserves. Accounting standards are especially important when a bank is considering selling or trading a loan at a loss, since they determine whether such transactions should reduce the value of a bank's entire portfolio to a debtor. For example, when Morgan Guaranty unveiled its plan for banks to swap existing Mexican loans for securities with a lower face value, the U.S. and Japanese governments issued accounting interpretations that permitted banks to isolate such a loss from the rest of their Mexico portfolios.[3]

Accounting standards are particularly influential in U.S. bank decisions because U.S. rules are relatively rigid and specific. Extensive disclosure requirements further magnify the importance of accounting judgments. In other countries, where most bookkeeping is confidential and accounting rules are more flexible, banks are freer to make decisions without worrying about how they will be recorded on the ledger.

Tax Policies

The principal tax issue affecting banks' Third world loan portfolios is the deductibility of reserves and losses. In most countries, banks set up specific reserves against problem loans and deduct these reserves from taxable income up to a level accepted by tax authorities, which is generally close to the reserve level suggested by regulators.

U.S. tax laws are not so generous. Banks have increased their general loan loss reserves in anticipation of Third world debt losses, without receiving a tax deduction. Instead, their general reserves count as capital. U.S. banks can deduct specific loan loss reserves, or the loss involved in "writing down" a loan to reflect reduced repayment prospects, only if tax authorities accept that full repayment of the loan is unlikely. Up to now, tax authorities have accepted such deductions only for loans to the few "value-impaired" countries.

Japan's tax policies are the strictest of the creditor countries. The Ministry of Finance allows tax deductions on only 1 per cent of the maximum 10 per cent loan loss reserves against troubled loans, and also limits bank losses on Third World debt. Since 1982, such losses on sovereign loans have been permitted twice. In 1987, Japanese banks sold $800 million of their Mexico exposure at a 43-per-cent discount to an offshore affiliate. In 1988, banks were permitted to exchange Mexican loans for new securities and take a partial loss.

These tax policy variations have had a predictable influence on bank behavior: European banks lead the world in reserves, while Japan's banks lag far behind. Japanese banks are increasingly reluctant to lend to troubled Third world borrowers without publicly raising reserves, and so they are pressing the Ministry of Finance for larger reserve limits and accompanying tax deductions as a quid pro quo for participating in new loans.

Business Judgment

In any creditor country, banks facing identical regulations can elect different strategies for managing Third World loans. Although banks presented a united front during the initial years of the debt crisis, their preferences have increasingly diverged. Small banks in particular have begun to exit from the Third World by selling or swapping their portfolios at a loss and by refusing to lend new funds. This strategy is less feasible for big banks with more of their balance sheets exposed to troubled debtors, and such banks have for the most part retained Third World exposure for strategic and financial reasons.

Because of the differences in outlook and loan exposure between U.S. regional and money-center banks, some argue that regulators should oversee the money-center banks separately. Such a framework could encourage more case-by-case supervision, which would better match the flexibility of other creditor-country regulations. Such special treatment for large banks and international loans, however, would be politically problematic in the face of continuing trouble in certain domestic banking sectors.

Harmonizing Bank Regulations

Regulatory coordination is difficult even within individual countries. Key regulations--in supervision, accounting, and taxation--generally evolve independently of one another, and often con-

Table 2. Reserves at Major U.S. Banks[a]

	Nonperforming loans as percentage of assets[b]	Reserves as percentage of primary capital[c]	Reserves as percentage of nonperforming loans[d]	Reserves as percentage of developing-country exposure[e]
Citicorp	3.2	20	77	25
Chase Manhattan	5.4	27	59	26
Bank of America	5.9	N.A.	55	25
Manufacturers Hanover	4.4	20	77	22
Chemical	4.3	26	72	25
Security Pacific	2.2	13	66	36
Bankers Trust	5.0	20	108	25
First Interstate	3.2	N.A.	75	33

[a]Banks are among U.S. top ten in assets.
[b]As of June 30, 1987.
[c]Based on reserves allocated by banks to cover losses on Third World loans, as of June 30, 1987.
[d]As of June 30, 1987.
[e]Reserves allocated to developing-country exposure as percentage of that exposure.
Sources: The Economist, August 1987; Journal of Commerce, June 22, 1987; p. 3A; author's estimates, based on data from IBCA Banking Analysis.

[3]The Wall Street Journal, January 26, 1988, p. 33.

flict. Supervisors may tell banks to boost loan loss reserves against specific countries, only to find tax authorities rejecting the banks' claims to a tax deduction. U.S. regulators who supported the Mexican debt-for-bonds swap proposal had to persuade the Securities and Exchange Commission to support accounting revisions that made the plan feasible for banks.[4]

Despite these problems, bank supervisors have made impressive progress in international cooperation. The Cooke Committee's capital requirement proposal can serve as a model for future harmonization efforts, such as work now underway in the European Economic Community to integrate its financial markets by 1992. The harmonization process will be slow and difficult because governments hesitate to part with long-held practices and privileges. Moreover, to achieve far-reaching international regulatory reform, all the regulatory bureaucracies and professions--including accountants, lawyers, tax collectors, and bank supervisors--will need to participate in negotiations.

The Menu Approach

Growing international financial interdependence will encourage governments to gradually harmonize banking regulations, but in the medium term bank regulators must focus on more specific means for easing the debt crisis. A promising strategy is the "menu approach" of offering several rescheduling choices to banks, which has been used recently to accommodate banks' differing preferences and to address the varying needs of debtor countries. In this spirit, recent accords have featured debt/equity and debt/security exchanges, exit bonds, and loans contingent on commodity prices and economic growth.

The menu approach avoids many of the regulatory obstacles to across-the-board debt resolution schemes by letting banks choose actions that best fit their regulatory environment and business strategies. For small banks that do not intend to pursue long-term ties with Third World economies, options that release them from future lending obligations are ideal. Internationally oriented banks prefer alternatives that strengthen their balance sheets and preserve their ties to important foreign clients.

Some menu options, however, are viable only if they win majority support among bank creditors with respect to a given debtor--either by voting to make the option available, or by taking part in the option when large-scale participation is needed to make a step (such as a debt/security swap) economically attractive to both borrower and lenders. Therefore, policymakers should encourage widespread bank interest in new options through regulatory flexibility.

Promoting Menu Options through Regulation

Regulators can encourage an expanded menu approach by giving banks more room to sample innovations. The following section outlines regulations in the major creditor countries on a variety of potential menu options, and suggests possible policy changes that could create a more flexible and consistent international regulatory climate.

Option: New loans to debtor country.

Relevant regulations:

United States: Banks must add to loan loss reserves only if the new loan is to a "value-impaired" debtor.

Japan: Banks may reserve against no more than 10 per cent of the new exposure.

United Kingdom: Reserve requirements depend on the strength of the debtor's economy and its loan repayment record and attitude.

Germany: Banks must reserve at the same level they had reserved against previous loans to a debtor, unless they are extending a trade credit.

France: Banks decide if new reserves are needed, subject to supervisory approval.

Switzerland: Banks must reserve at the same level they had reserved against previous loans to a country for all new exposure, including trade credits.

Canada: Banks must reserve at the same level they had reserved against previous exposure, excluding trade credits.

Possible regulatory changes:

The United States could revise the criteria for "value-impaired" status and mandatory reserves to downplay the "180-day rule." Elimination of Japan's reserve ceiling would give Japanese banks more freedom of action.

Option: Interest capitalization.

Relevant regulations:

All major creditor countries: Banks may capitalize interest (i.e., add uncollected interest to loan principal), but may not count such interest as income until it is received.

Additional rules in the United States: Banks may capitalize interest if eventual full repayment of the loan appears likely.

Additional rules in Switzerland and Germany: Banks must reserve against capitalized interest just as they do new loans, so regulations neither encourage nor discourage the practice.

Possible regulatory changes:

U.S. regulators could specify country cases in which they would deem interest capitalization acceptable, so that banks would be certain of their options.

Option: Debt/equity swaps.

Relevant regulations:

United States: Banks may swap loans at a discount to buy up to 100 per cent of equity in nonfinancial companies that are being privatized in debtor countries, or up to 40 per cent of existing private companies. In either case, banks must sell their interest within fifteen years. Banks may deduct a loss if they swap their loans at a discount. They can also deduct loan contributions to nonprofit environmental and humanitarian organizations, which then swap the loans for debtors' local currency or for actions that preserve the environment.

Japan: Japanese banks may swap loans for equity in any kind of foreign concern. Official approval is needed for banks to accept a discount--i.e., a loss--on the transaction.

Other creditor countries: No restrictions.

Possible regulatory changes:

The Japanese Ministry of Finance could give blanket permission to banks for discounted debt/equity swaps.

Option: Principal relief (including exit bonds, discounted loan/security swaps, and simple forgiveness).

Relevant regulations:

United States: Banks subtract loan losses, whether voluntary or involuntary, from their reserves, or if these are exhausted, from current earnings and equity. An accounting rule (FASB-15) designed for certain kinds of domestic loans allows banks to forgive loan principal without deducting the amount forgiven from loan loss reserves, if the loan has been rescheduled so that the sum of future interest payments will at least equal the amount of debt forgiven. Their loss thus is realized gradually, over the life of the loan. The availability of FASB-15 accounting for Third World loans is uncertain, since it was not designed for use on this type of lending.

[4] Assistant Treasury Secretary David C. Mulford has testified before Congress on the importance of accounting changes to the Mexico plan. See "Recent Development in International Debt," testimony before the House Banking Subcommittees on International Development Institutions and on International Finance, Trade, and Monetary Policy, February 4, 1988.

Japan: Principal relief is permitted only with Ministry of Finance approval.

Other countries: As in the United States, the loss of principal can be deducted from loan loss reserves, current earnings, or equity.

Possible regulatory changes:

U.S. and other creditor-country regulators could institute an accounting rule similar to FASB-15 to make it easier for banks to offer limited principal relief to Third World borrowers.

Option: Interest relief.

Relevant regulations:

United States: The accounting rule mentioned above for forgiving principal (FASB-15) also allows interest relief (i.e., interest below banks' cost of funds) without requiring banks to draw down reserves.

Japan: Permitted only with Ministry of Finance approval.

Other countries: No restrictions.

Possible regulatory changes:

Same as for principal relief.

Further Policy Recommendations

The new era of flexible response to the debt crisis creates opportunities for public policy. Creditor-country governments can foster bank cooperation and facilitate an orderly settlement of the Third World debt tangle by harmonizing their tax, accounting, and supervisory policies. They can also encourage innovations that need not be applied universally to banks or borrowers by using the expanded menu approach.

In addition to the measures recommended above for promoting various menu options, banking regulators in the United States and the other major creditor nations should consider more far-reaching regulatory initiatives to speed progress in the debt crisis.

Policymakers who set accounting and tax standards for banks should meet in international forums akin to the Cooke Committee, perhaps sponsored by the OECD or the IMF. Within and across specialties, banking regulators need to discuss the international impact of their decisions and to search for policy changes that could help resolve the Third World debt problem. A priority, in both domestic and international discussions, should be coordinating the intersection between taxation and loan loss reserves policies. Harmonization efforts are likely to move slowly, but at a minimum they will familiarize regulators with one another's policies.

In the United States, France, and other countries where bank regulatory powers are distributed among several branches of government, the various authorities need to work closely together to assist Third World debt strategy. In the United States, streamlining supervision of the money-center banks, perhaps by placing all their operations under Federal Reserve Board oversight, would assist flexible and focused policymaking on Third World debt. Such a plan raises important issues concerning accountability and centralization of financial regulatory power and should be considered alongside broader proposals to reform U.S. financial regulation.

In the United States, a more sophisticated and flexible system of country-risk evaluation, such as the Bank of England's matrix of indicators of a debtor's willingness and ability to make payments, could further refine risk evaluation and would be an important gesture of regulatory harmonization. Current U.S. regulations cause friction among banks internationally because of one of the factors they use to assess risk: whether a country falls 180 days behind on scheduled debt payments. On the positive side, current U.S. rules for country-risk evaluation have pressed debtors and creditors to reach agreements.

The Japanese Ministry of Finance should allow banks to increase taxable loan loss reserves at will and to declare losses whenever they deem appropriate. Such measures would encourage banks to feel secure in lending new sums to Third World debtors and to participate in discounted debt swaps. Even with such a change, Japanese tax policies would be less generous than those of other creditor countries. A next step could be to make specific reserves deductible, as long as they fall within the global average. The revenue shortfall from such a step might reach $3-4 billion over several years, but other forms of taxation could recapture revenues while encouraging Japanese banks to catch up with their international peers in declared reserve levels.

These policy initiatives, along with a heightened awareness among bank regulators of the need for flexibility and innovation, would help the world's commercial banks cooperate with one another and with debtor countries to forge constructive solutions to the debt crisis.

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for the Overseas Development Council
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from 1986 to 1987 was less than the 32% rise in U.S. exports to the LDCs. LDC exports to Japan, on the other hand, suffered only a $1 billion drop between 1981 and 1986, almost all of which was recovered in 1987. Japan last year ran a small $410 million trade surplus with the heavily indebted LDCs (Table A).

Canada's trade position with the LDCs (Table 8) is similar to Japan's. Exports to the LDCs were down by almost a billion (30%) from 1981 to 1987, with only a 13% recovery from 1986's low point. LDC exports to Canada fell between 1981 and 1986, but, unlike LDC exports to Japan, showed little rebound in 1987. Canada in 1987 had a $1 billion trade deficit with the indebted LDCs (Table A).

Table 1
Exports and Imports of Goods of
Seventeen Highly Indebted Countries
To/From the United States
(Billions of Dollars)

	Exports from LDC:			Imports to LDC:		
	1981	1986	1987	1981	1986	1987
Argentina	0.9	0.7	0.9	2.1	0.8	1.0
Bolivia	0.3	0.1	0.1	0.2	0.1	0.2
Brazil	4.1	6.3	7.7	3.9	3.5	3.4
Chile	0.6	0.9	1.0	1.6	0.6	0.8
Colombia	0.7	1.5	2.2	1.8	1.4	1.6
Costa Rica	0.3	0.5	0.7	0.4	0.4	0.6
Ecuador	1.0	1.3	1.2	0.8	0.5	0.6
Ivory Coast	0.3	0.4	0.4	0.1	0.1	0.1
Jamaica	0.4	0.2	0.4	0.5	0.5	0.7
Mexico	10.7	11.2	18.7	14.0	8.3	14.6
Morocco	0.0	0.0	0.0	0.3	0.4	0.4
Nigeria	6.4	2.4	3.4	2.2	0.5	0.3
Peru	1.1	0.8	0.7	1.1	0.5	0.8
Philippines	1.8	1.7	2.1	1.9	1.3	1.5
Uruguay	0.1	0.1	0.2	0.2	0.1	0.1
Venezuela	5.1	3.8	5.3	5.8	3.5	3.6
Yugoslavia	0.4	0.6	0.8	1.0	0.7	0.4
Total	34.2	32.5	45.8	37.9	23.2	30.7
Memo Items:						
Total w/o Mexico, Brazil	19.4	15.0	19.4	20.0	11.4	12.7
All Developing Countries	120.9	115.1	136.1	95.7	72.8	82.7

	Exports from LDC:			Imports to LDC:		
	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987
Argentina	-0.2	0.0	0.2	-1.3	-1.1	0.2
Bolivia	-0.2	-0.2	0.0	-0.1	0.0	0.1
Brazil	2.2	3.6	1.4	-0.4	-0.5	-0.1
Chile	0.3	0.4	0.1	-1.0	-0.8	0.2
Colombia	0.8	1.5	0.7	-0.4	-0.2	0.2
Costa Rica	0.2	0.4	0.2	0.0	0.2	0.2
Ecuador	0.3	0.2	-0.1	-0.3	-0.2	0.1
Ivory Coast	0.1	0.1	0.0	0.0	0.0	0.0
Jamaica	-0.2	0.0	0.2	0.0	0.2	0.2
Mexico	0.5	8.0	7.5	-5.7	0.6	6.3
Morocco	0.0	0.0	0.0	0.1	0.1	0.0
Nigeria	-4.0	-3.0	1.0	-1.7	-1.9	-0.2
Peru	-0.3	-0.4	-0.1	-0.6	-0.3	0.3
Philippines	-0.1	0.3	0.4	-0.6	-0.4	0.2
Uruguay	0.0	0.1	0.1	-0.1	-0.1	0.0
Venezuela	-1.3	0.2	1.5	-2.3	-2.2	0.1
Yugoslavia	0.2	0.4	0.2	-0.3	-0.6	-0.3
Total	-1.7	11.6	13.3	-14.7	-7.2	7.5
Memo Items:						
Total w/o Mexico, Brazil	-4.4	0.0	4.4	-8.6	-7.3	1.3
All Developing Countries	-5.8	15.2	21.0	-22.9	-13.0	9.9

Source: IMF, "Direction of Trade Statistics, Yearbook, 1988"

Table 2
Exports and Imports of Goods of
Seventeen Highly Indebted Countries
To/From Industrial Countries
(Billions of Dollars)

	Exports from LDC:			Imports to LDC:		
	1981	1986	1987	1981	1986	1987
Argentina	3.4	3.1	3.2	6.5	2.8	3.7
Bolivia	0.5	0.2	0.2	0.5	0.3	0.3
Brazil	12.5	14.8	18.4	10.0	9.1	9.3
Chile	2.5	2.9	3.2	3.9	1.8	2.4
Colombia	2.1	4.3	4.3	3.7	2.9	3.5
Costa Rica	0.6	0.9	1.2	0.7	0.8	1.0
Ecuador	1.4	1.6	1.5	1.7	1.3	1.4
Ivory Coast	1.8	2.4	2.2	1.5	1.4	1.5
Jamaica	0.8	0.5	0.7	0.9	0.7	1.2
Mexico	16.2	14.7	24.4	19.2	11.5	18.9
Morocco	1.5	1.6	1.9	2.7	2.8	3.1
Nigeria	13.5	7.0	6.8	17.2	4.2	3.9
Peru	2.2	1.7	1.8	2.3	1.2	2.0
Philippines	4.2	3.6	4.3	5.0	3.1	4.0
Uruguay	0.5	0.5	0.6	0.6	0.3	0.4
Venezuela	11.6	5.7	7.5	10.4	6.5	7.1
Yugoslavia	3.4	3.5	6.2	8.2	5.5	8.1
Total	78.7	69.0	88.4	95.0	56.2	71.8
Memo Items:						
Total w/o Mexico, Brazil	50.0	39.5	45.6	65.8	35.6	43.6
All Developing Countries	372.8	289.8	360.4	371.8	377.9	325.8

	Exports from LDC:			Imports to LDC:		
	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987
Argentina	-0.3	-0.2	0.1	-3.7	-2.8	0.9
Bolivia	-0.3	-0.3	0.0	-0.2	-0.2	0.0
Brazil	2.3	5.9	3.6	-0.9	-0.7	0.2
Chile	0.4	0.7	0.3	-2.1	-1.5	0.6
Colombia	2.2	2.2	0.0	-0.8	-0.2	0.6
Costa Rica	0.3	0.6	0.3	0.1	0.3	0.2
Ecuador	0.2	0.1	-0.1	-0.4	-0.3	0.1
Ivory Coast	0.6	0.4	-0.2	-0.1	0.0	0.1
Jamaica	-0.3	-0.1	0.2	-0.2	0.3	0.5
Mexico	-1.5	8.2	9.7	-7.7	-0.3	7.4
Morocco	0.1	0.4	0.3	0.1	0.4	0.3
Nigeria	-6.5	-6.7	-0.2	-13.0	-13.3	-0.3
Peru	-0.5	-0.4	0.1	-1.1	-0.3	0.8
Philippines	-0.8	0.1	0.7	-1.9	-1.0	0.9
Uruguay	0.0	0.1	0.1	-0.3	-0.2	0.1
Venezuela	-5.9	-4.1	1.8	-3.9	-3.3	0.6
Yugoslavia	0.1	2.8	2.7	-2.7	-0.1	2.6
Total	-9.7	9.7	19.4	-38.8	-23.2	15.6
Memo Items:						
Total w/o Mexico, Brazil	-10.5	-4.4	6.1	-30.2	-22.2	8.0
All Developing Countries	-83.0	-12.4	70.6	6.1	-46.0	-52.1

Source: IMF, "Direction of Trade Statistics, Yearbook, 1988"

Table 3
Exports and Imports of Goods of
Seventeen Highly Indebted Countries
To/From the World
(Billions of Dollars)

	Exports from LDC:			Imports to LDC:		
	1981	1986	1987	1981	1986	1987
Argentina	9.1	6.9	6.4	9.4	4.7	5.9
Bolivia	1.0	0.6	0.6	0.9	0.6	0.8
Brazil	23.3	22.4	26.6	24.1	15.6	16.6
Chile	3.9	4.2	4.9	6.4	3.1	4.2
Colombia	3.0	5.1	5.2	5.2	3.9	4.5
Costa Rica	1.0	1.1	1.4	1.2	1.4	1.4
Ecuador	2.5	2.2	2.0	2.2	1.8	1.9
Ivory Coast	2.5	3.4	3.2	2.4	2.0	2.2
Jamaica	1.0	0.6	0.9	1.5	1.0	1.5
Mexico	19.4	16.6	26.8	21.9	12.3	19.8
Morocco	2.3	2.4	2.8	4.4	3.9	4.3
Nigeria	17.9	8.4	8.3	20.4	5.6	5.4
Peru	3.2	2.5	2.6	3.4	1.7	3.1
Philippines	5.7	4.8	5.7	8.5	5.2	6.9
Uruguay	1.2	1.1	1.2	1.6	0.9	1.1
Venezuela	20.0	8.4	10.6	12.1	7.6	8.2
Yugoslavia	10.9	10.3	13.1	15.8	11.8	14.3
Total	127.9	101.0	122.4	141.4	83.2	102.1
Memo Items:						
Total w/o Mexico, Brazil	85.2	62.0	69.0	95.4	55.3	65.7
All Developing Countries	612.7	480.5	584.0	604.9	513.4	599.0

	Exports from LDC:			Imports to LDC:		
	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987
Argentina	-2.2	-2.7	-0.5	-4.7	-3.5	1.2
Bolivia	-0.4	-0.4	0.0	-0.3	-0.1	0.2
Brazil	-0.9	3.3	4.2	-8.5	-7.5	1.0
Chile	0.3	1.0	0.7	-3.3	-2.2	1.1
Colombia	2.1	2.2	0.1	-1.3	-0.7	0.6
Costa Rica	0.1	0.4	0.3	0.2	0.2	0.0
Ecuador	-0.3	-0.5	-0.2	-0.4	-0.3	0.1
Ivory Coast	0.9	0.7	-0.2	-0.4	-0.2	0.2
Jamaica	-0.4	-0.1	0.3	-0.5	0.0	0.5
Mexico	-2.8	7.4	10.2	-9.6	-2.1	7.5
Morocco	0.1	0.5	0.4	-0.5	-0.1	0.4
Nigeria	-9.5	-9.6	-0.1	-14.8	-15.0	-0.2
Peru	-0.7	-0.6	0.1	-1.7	-0.3	1.4
Philippines	-0.9	0.0	0.9	-3.3	-1.6	1.7
Uruguay	-0.1	0.0	0.1	-0.7	-0.5	0.2
Venezuela	-11.6	-9.4	2.2	-4.5	-3.9	0.6
Yugoslavia	-0.6	2.2	2.8	-4.0	-1.5	2.5
Total	-26.9	-5.6	21.4	-58.2	-39.3	19.0
Memo Items:						
Total w/o Mexico, Brazil	-23.2	-16.3	7.0	-40.1	-29.7	10.5
All Developing Countries	-132.2	-28.7	103.5	-91.5	-5.9	85.6

Source: IMF, "Direction of Trade Statistics, Yearbook, 1988"

Table 4
Exports and Imports of Goods of
Seventeen Highly Indebted Countries
To/From Non-U.S. Industrial World
(Billions of Dollars)

	---Exports from LDC:--			----Imports to LDC:---		
	1981	1986	1987	1981	1986	1987
Argentina	2.5	2.4	2.3	4.4	2.0	2.7
Bolivia	0.2	0.1	0.1	0.3	0.2	0.1
Brazil	8.4	8.5	10.7	6.1	5.6	5.9
Chile	1.9	2.0	2.2	2.3	1.2	1.6
Colombia	1.4	2.8	2.1	1.9	1.5	1.9
Costa Rica	0.3	0.4	0.5	0.3	0.4	0.4
Ecuador	0.4	0.3	0.3	0.9	0.8	0.8
Ivory Coast	1.5	2.0	1.8	1.4	1.3	1.4
Jamaica	0.4	0.3	0.3	0.4	0.2	0.5
Mexico	5.5	3.5	5.7	5.2	3.2	4.3
Morocco	1.5	1.6	1.9	2.4	2.4	2.7
Nigeria	7.1	4.6	3.4	15.0	3.7	3.6
Peru	1.1	0.9	1.1	1.2	0.7	1.2
Philippines	2.4	1.9	2.2	3.1	1.8	2.5
Uruguay	0.4	0.4	0.4	0.4	0.2	0.3
Venezuela	6.5	1.9	2.2	4.6	3.0	3.5
Yugoslavia	3.0	2.9	5.4	7.2	4.8	7.7
Total	44.5	36.5	42.6	57.1	33.0	41.1
Memo Items:						
Total w/o Mexico, Brazil	30.6	24.5	26.2	45.8	24.2	30.9
All Developing Countries	251.9	174.7	224.3	276.1	305.1	243.1

	---Exports from LDC:--			----Imports to LDC:---		
	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987
Argentina	-0.1	-0.2	-0.1	-2.4	-1.7	0.7
Bolivia	-0.1	-0.1	0.0	-0.1	-0.2	-0.1
Brazil	0.1	2.3	2.2	-0.5	-0.2	0.3
Chile	0.1	0.3	0.2	-1.1	-0.7	0.4
Colombia	1.4	0.7	-0.7	-0.4	0.0	0.4
Costa Rica	0.1	0.2	0.1	0.1	0.1	0.0
Ecuador	-0.1	-0.1	0.0	-0.1	-0.1	0.0
Ivory Coast	0.5	0.3	-0.2	-0.1	0.0	0.1
Jamaica	-0.1	-0.1	0.0	-0.2	0.1	0.3
Mexico	-2.0	0.2	2.2	-2.0	-0.9	1.1
Morocco	0.1	0.4	0.3	0.0	0.3	0.3
Nigeria	-2.5	-3.7	-1.2	-11.3	-11.4	-0.1
Peru	-0.2	0.0	0.2	-0.5	0.0	0.5
Philippines	-0.5	-0.2	0.3	-1.3	-0.6	0.7
Uruguay	0.0	0.0	0.0	-0.2	-0.1	0.1
Venezuela	-4.6	-4.3	0.3	-1.6	-1.1	0.5
Yugoslavia	-0.1	2.4	2.5	-2.4	0.5	2.9
Total	-8.0	-1.9	6.1	-24.1	-15.0	8.1
Memo Items:						
Total w/o Mexico, Brazil	-6.1	-4.4	1.7	-21.6	-14.9	6.7
All Developing Countries	-77.2	-27.6	49.6	29.0	-33.0	-62.0

Source: IMF, "Direction of Trade Statistics, Yearbook, 1988"

Table 5
Exports and Imports of Goods of
Seventeen Highly Indebted Countries -
To/From Non-Industrial World
(Billions of Dollars)

	---Exports from LDC.--			----Imports to LDC:---		
	1981	1986	1987	1981	1986	1987
Argentina	5.7	3.8	3.2	2.9	1.9	2.2
Bolivia	0.5	0.4	0.4	0.4	0.3	0.5
Brazil	10.8	7.6	8.2	14.1	6.5	7.3
Chile	1.4	1.3	1.7	2.5	1.3	1.8
Colombia	0.9	0.8	0.9	1.5	1.0	1.0
Costa Rica	0.4	0.2	0.2	0.5	0.6	0.4
Ecuador	1.1	0.6	0.5	0.5	0.5	0.5
Ivory Coast	0.7	1.0	1.0	0.9	0.6	0.7
Jamaica	0.2	0.1	0.2	0.6	0.3	0.3
Mexico	3.2	1.9	2.4	2.7	0.8	0.9
Morocco	0.8	0.8	0.9	1.7	1.1	1.2
Nigeria	4.4	1.4	1.5	3.2	1.4	1.5
Peru	1.0	0.8	0.8	1.1	0.5	1.1
Philippines	1.5	1.2	1.4	3.5	2.1	2.9
Uruguay	0.7	0.6	0.6	1.0	0.6	0.7
Venezuela	8.4	2.7	3.1	1.7	1.1	1.1
Yugoslavia	7.5	6.8	6.9	7.6	6.3	6.2
Total	49.2	32.0	34.0	46.4	27.0	30.3
Memo Items:						
Total w/o Mexico, Brazil	35.2	22.5	23.4	29.6	18.7	22.1
All Developing Countries	239.9	190.7	223.6	233.1	135.5	273.2

	---Exports from LDC:--			----Imports to LDC:---		
	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987
Argentina	-1.9	-2.5	-0.6	-1.0	-0.7	0.3
Bolivia	-0.1	-0.1	0.0	-0.1	0.1	0.2
Brazil	-3.2	-2.6	0.6	-7.6	-6.8	0.8
Chile	-0.1	0.3	0.4	-1.2	-0.7	0.5
Colombia	-0.1	0.0	0.1	-0.5	-0.5	0.0
Costa Rica	-0.2	-0.2	0.0	0.1	-0.1	-0.2
Ecuador	-0.5	-0.6	-0.1	0.0	0.0	0.0
Ivory Coast	0.3	0.3	0.0	-0.3	-0.2	0.1
Jamaica	-0.1	0.0	0.1	-0.3	-0.3	0.0
Mexico	-1.3	-0.8	0.5	-1.9	-1.8	0.1
Morocco	0.0	0.1	0.1	-0.6	-0.5	0.1
Nigeria	-3.0	-2.9	0.1	-1.8	-1.7	0.1
Peru	-0.2	-0.2	0.0	-0.6	0.0	0.6
Philippines	-0.3	-0.1	0.2	-1.4	-0.6	0.8
Uruguay	-0.1	-0.1	0.0	-0.4	-0.3	0.1
Venezuela	-5.7	-5.3	0.4	-0.6	-0.6	0.0
Yugoslavia	-0.7	-0.6	0.1	-1.3	-1.4	-0.1
Total	-17.2	-15.3	2.0	-19.4	-16.1	3.4
Memo Items:						
Total w/o Mexico, Brazil	-12.7	-11.9	0.9	-9.9	-7.5	2.5
All Developing Countries	-49.2	-16.3	32.9	-97.6	40.1	137.7

Source: IMF, "Direction of Trade Statistics, Yearbook, 1988"

Table 6
Exports and Imports of Goods of
Seventeen Highly Indebted Countries
To/From European Economic Community
(Billions of Dollars)

	Exports from LDC:			Imports to LDC:		
	1981	1986	1987	1981	1986	1987
Argentina	2.2	2.0	1.9	2.8	1.4	1.9
Bolivia	0.2	0.1	0.1	0.2	0.1	0.1
Brazil	6.4	5.9	7.6	3.4	3.5	3.6
Chile	1.3	1.4	1.5	1.3	0.7	1.0
Colombia	1.1	2.0	1.5	1.0	0.9	1.0
Costa Rica	0.2	0.3	0.3	0.2	0.2	0.2
Ecuador	0.1	0.2	0.2	0.4	0.4	0.5
Ivory Coast	1.5	2.0	1.8	1.2	1.2	1.3
Jamaica	0.2	0.2	0.2	0.2	0.1	0.3
Mexico	5.6	2.1	3.2	3.2	1.8	2.1
Morocco	1.3	1.4	1.7	2.1	2.0	2.3
Nigeria	6.7	4.1	3.1	11.3	3.2	2.9
Peru	0.5	0.6	0.7	0.6	0.4	0.7
Philippines	0.9	0.9	1.1	0.9	0.6	0.8
Uruguay	0.4	0.3	0.3	0.3	0.2	0.2
Venezuela	3.8	1.3	1.3	2.8	2.1	2.4
Yugoslavia	2.5	2.6	4.9	5.8	3.9	6.3
Total	33.0	27.3	31.4	37.6	22.4	27.7
Memo Items:						
Total w/o Mexico, Brazil	28.2	23.8	26.3	33.0	19.6	24.6
All Developing Countries	164.9	144.2	163.2	183.0	138.3	161.8

	Exports from LDC:			Imports to LDC:		
	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987
Argentina	-0.2	-0.3	-0.1	-1.4	-0.9	0.5
Bolivia	-0.1	-0.1	0.0	-0.1	-0.1	0.0
Brazil	0.3	0.7	0.4	-0.4	-0.4	0.0
Chile	0.0	0.1	0.1	-0.4	-0.3	0.1
Colombia	1.0	0.4	-0.5	-0.1	0.0	0.1
Costa Rica	0.1	0.1	0.0	0.0	0.0	0.0
Ecuador	0.1	0.1	0.0	0.0	0.0	0.0
Ivory Coast	0.5	0.3	-0.1	0.0	0.1	0.1
Jamaica	0.0	0.0	0.1	-0.1	0.2	0.2
Mexico	-1.5	-0.3	1.2	-1.4	-1.1	0.4
Morocco	0.1	0.4	0.3	-0.1	0.2	0.3
Nigeria	-2.5	-3.5	-1.0	-8.2	-8.4	-0.3
Peru	0.1	0.1	0.0	-0.3	0.0	0.3
Philippines	-0.1	0.1	0.2	-0.3	-0.1	0.3
Uruguay	-0.1	0.0	0.1	-0.1	0.0	0.1
Venezuela	-2.5	-2.5	-0.1	-0.7	-0.4	0.3
Yugoslavia	0.1	2.4	2.3	-1.9	0.5	2.4
Total	-5.6	-1.5	4.1	-15.2	-9.9	5.3
Memo Items:						
Total w/o Mexico, Brazil	-4.4	-1.9	2.5	-13.4	-8.4	4.9
All Developing Countries	-20.7	-1.7	19.0	-44.7	-21.2	23.5

Source: IMF, "Direction of Trade Statistics, Yearbook, 1988"

Table 7
Exports and Imports of Goods of
Seventeen Highly Indebted Countries
To/From Japan
(Billions of Dollars)

	---Exports from LDC:--			----Imports to LDC:---		
	1981	1986	1987	1981	1986	1987
Argentina	0.17	0.39	0.23	0.97	0.34	0.40
Bolivia	0.00	0.00	0.00	0.10	0.03	0.05
Brazil	1.20	1.50	1.87	1.38	0.98	0.94
Chile	0.43	0.42	0.53	0.67	0.30	0.38
Colombia	0.13	0.25	0.21	0.50	0.35	0.43
Costa Rica	0.00	0.00	0.01	0.12	0.12	0.12
Ecuador	0.31	0.06	0.05	0.26	0.21	0.26
Ivory Coast	0.05	0.04	0.02	0.12	0.11	0.10
Jamaica	0.00	0.00	0.00	0.04	0.04	0.04
Mexico	1.16	1.07	1.50	1.10	0.77	.40
Morocco	0.07	0.12	0.13	0.08	0.07	0.05
Nigeria	0.26	0.00	0.00	2.73	0.22	0.38
Peru	0.48	0.27	0.27	0.30	0.17	0.23
Philippines	1.25	0.85	0.98	1.61	0.89	1.15
Uruguay	0.01	0.01	0.02	0.08	0.03	0.04
Venezuela	0.78	0.28	0.33	0.97	0.53	0.50
Yugoslavia	0.03	0.02	0.03	0.17	0.15	0.11
Total	6.31	5.27	6.17	11.19	5.29	6.58
Memo Items:						
Total w/o Mexico, Brazil	3.95	2.71	2.81	8.71	3.53	4.24
All Developing Countries	70.10	62.25	74.08	88.55	60.10	71.10

	---Exports from LDC:--			----Imports to LDC:---		
	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987
Argentina	0.22	0.07	-0.16	-0.63	-0.57	0.06
Bolivia	0.00	0.00	0.00	-0.07	-0.05	0.02
Brazil	0.30	0.37	-0.49	-0.40	-0.04	-0.94
Chile	-0.01	0.11	0.14	-0.37	0.09	-0.38
Colombia	0.12	0.08	-0.04	-0.15	-0.07	0.08
Costa Rica	0.00	0.01	0.01	0.00	0.01	0.00
Ecuador	-0.25	-0.26	-0.01	-0.06	-0.01	0.05
Ivory Coast	-0.01	-0.03	-0.02	-0.01	-0.02	-0.01
Jamaica	0.00	0.00	0.00	0.00	0.00	0.00
Mexico	-0.09	0.34	0.44	-0.33	0.30	0.63
Morocco	0.05	0.06	0.01	-0.02	-0.03	-0.01
Nigeria	-0.26	-0.26	0.00	-2.51	-2.35	0.16
Peru	-0.21	-0.21	0.01	-0.13	-0.07	0.06
Philippines	-0.40	-0.27	0.13	-0.72	-0.46	0.26
Uruguay	0.00	0.01	0.01	-0.05	-0.04	0.01
Venezuela	-0.50	-0.45	0.05	-0.44	-0.47	-0.03
Yugoslavia	-0.01	0.00	0.01	-0.02	-0.06	-0.04
Total	-1.04	-0.14	0.90	-5.91	-4.61	1.30
Memo Items:						
Total w/o Mexico, Brazil	-1.25	-1.15	0.10	-5.18	-4.47	0.71
All Developing Countries	-7.85	3.98	11.83	-28.45	-17.45	11.00

Source: IMF, "Direction of Trade Statistics, Yearbook, 1988"

Table 8
Exports and Imports of Goods of
Seventeen Highly Indebted Countries
To/From Canada
(Billions of Dollars)

	---Exports from LDC:--			----Imports to LDC:---		
	1981	1986	1987	1981	1986	1987
Argentina	0.07	0.06	0.08	0.14	0.05	0.08
Bolivia	0.02	0.01	0.00	0.01	0.01	0.00
Brazil	0.36	0.59	0.64	0.61	0.57	0.48
Chile	0.09	0.09	0.12	0.10	0.06	0.08
Colombia	0.07	0.09	0.10	0.17	0.13	0.20
Costa Rica	0.03	0.04	0.05	0.02	0.02	0.03
Ecuador	0.04	0.07	0.07	0.08	0.06	0.03
Ivory Coast	0.01	0.01	0.01	0.02	0.01	0.01
Jamaica	0.08	0.10	0.09	0.07	0.05	0.07
Mexico	0.80	0.85	0.89	0.61	0.29	0.40
Morocco	0.01	0.01	0.02	0.08	0.11	0.16
Nigeria	0.09	0.25	0.18	0.08	0.02	0.02
Peru	0.04	0.05	0.06	0.08	0.08	0.09
Philippines	0.15	0.15	0.20	0.07	0.04	0.09
Uruguay	0.01	0.01	0.10	0.02	0.01	0.02
Venezuela	1.99	0.37	0.41	0.70	0.29	0.29
Yugoslavia	0.03	0.03	0.05	0.07	0.03	0.01
Total	3.87	2.78	3.07	2.91	1.82	2.06
Memo Items:						
Total w/o Mexico, Brazil	2.71	1.34	1.54	1.70	0.96	1.18
All Developing Countries	9.08	7.26	8.08	7.93	6.31	7.40

	---Exports from LDC:--			----Imports to LDC:---		
	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987
Argentina	0.00	0.02	0.02	-0.10	-0.07	0.03
Bolivia	-0.01	-0.01	0.00	0.00	-0.01	0.00
Brazil	0.23	0.05	-0.04	-0.04	-0.08	-0.48
Chile	0.00	0.02	-0.01	-0.04	0.01	-0.08
Colombia	0.02	0.03	0.01	-0.03	0.03	0.07
Costa Rica	0.01	0.02	0.01	0.00	0.01	0.01
Ecuador	0.03	0.03	0.01	-0.02	-0.05	-0.03
Ivory Coast	0.00	0.00	0.00	-0.01	-0.01	0.00
Jamaica	0.02	0.00	-0.02	-0.01	0.01	0.02
Mexico	0.05	0.09	0.04	-0.32	-0.21	0.11
Morocco	0.00	0.01	0.01	0.03	0.08	0.05
Nigeria	0.16	0.09	-0.07	-0.06	-0.07	0.00
Peru	0.00	0.01	0.01	0.00	0.01	0.01
Philippines	0.00	0.05	0.05	-0.03	0.02	0.06
Uruguay	0.00	0.09	0.09	-0.01	0.01	0.01
Venezuela	-1.62	-1.57	0.05	-0.41	-0.41	0.00
Yugoslavia	0.01	0.03	0.02	-0.04	-0.06	-0.02
Total	-1.08	-0.80	0.29	-1.09	-0.85	0.24
Memo Items:						
Total w/o Mexico, Brazil	-1.37	-1.17	0.20	-0.73	-0.52	0.22
All Developing Countries	-1.82	-1.00	0.82	-1.62	-0.53	1.09

Source: IMF, "Direction of Trade Statistics, Yearbook, 1988"

Table A
Exports and Imports of Goods of
Seventeen Highly Indebted Countries
Summary
(Billions of Dollars)

	--Exports from LDCs:--			---Imports to LDCs:---			Balance of Trade of LDCs		
	1981	1986	1987	1981	1986	1987	1981	1986	1987
Goods & Services (1)									
World	167.1	132.3	139.7	222.8	150.4	156.5	-55.7	-18.1	-16.8
Merchandise Goods Only (2)									
World	127.9	101.0	122.4	141.4	83.2	102.1	-13.5	17.8	20.2
Developing Countries	49.2	32.0	34.0	46.4	27.0	30.3	2.8	5.0	3.6
Industrial Countries	78.7	69.0	88.4	95.0	56.2	71.8	-16.3	12.8	16.6
United States	34.2	32.5	45.8	37.9	23.2	30.7	-3.7	9.3	15.1
Non-United States	44.5	36.5	42.6	57.1	33.0	41.1	-12.6	3.5	1.5
Europe	33.0	27.3	31.4	37.6	22.4	27.7	-4.6	5.0	3.8
Japan	6.3	5.3	6.2	11.2	5.3	6.6	-4.9	0.0	-0.4
Canada	3.9	2.8	3.1	2.9	1.8	2.1	1.0	1.0	1.0

	--Exports from LDCs:--			---Imports to LDCs:---			Balance of Trade of LDCs		
	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987	Change 1981 to 1986	Change 1981 to 1987	Change 1986 to 1987
Goods & Services (1)									
World	-34.8	-27.4	7.4	-72.4	-66.3	6.1	37.6	38.9	1.3
Merchandise Goods Only (2)									
World	-26.9	-5.6	21.4	-58.2	-39.3	19.0	31.3	33.7	2.4
Developing Countries	-17.2	-15.3	2.0	-19.4	-16.1	3.4	2.2	0.8	-1.4
Industrial Countries	-9.7	9.7	19.4	-38.8	-23.2	15.6	29.1	32.9	3.8
United States	-1.7	11.6	13.3	-14.7	-7.2	7.5	13.0	18.8	5.8
Non-United States	-8.0	-1.9	6.1	-24.1	-16.0	8.1	16.1	14.1	-2.0
Europe	-5.6	-1.5	4.1	-15.2	-9.9	5.3	9.6	8.4	-1.2
Japan	-1.0	-0.1	0.9	-5.9	-4.6	1.3	4.9	4.5	-0.4
Canada	-1.1	-0.8	0.3	-1.1	-0.9	0.2	0.0	0.1	0.0

Source: (1) IMF, "International Financial Statistics," September 1988
(2) IMF, "Direction of Trade Statistics, Yearbook, 1988"

Senator GRAHAM. Thank you. Thank you, Mr. Chairman.

Senator SARBANES. Let me just add, I think that is a very important point. I will never forget a seminar I attended in which a representative of the Boeing Co. and a representative of one of the major money center banks almost came to fisticuffs over this issue. At the time there was one of these countries that had been put on a very tight austerity program, and the Boeing representative took the attitude that in effect the banks were largely being paid out of the hide of the Boeing Co. and its workers because these countries which had been pushed to this austerity program had ceased to be customers, which would otherwise have been the case, for Boeing airplanes. And the country—the developing countries and this austerity program to produce the reserves with which to pay their financial obligations, but one consequence of that was that they ceased to be customers of Boeing.

There was a direct clash between the trade dimension and the financial obligation dimension.

Mr. ROBINSON. Boeing was right.

Senator SARBANES. Let me ask you a couple of questions.

Some concern has been raised that any approach which provides debt reduction as one of the options of dealing with the debt of developing countries would put an end to any new commercial bank lending to these countries.

How do you respond to that concern, and what role do you envision for commercial banks under the approach which you have set out in I2D2?

ROLE OF COMMERCIAL BANKS

Mr. ROBINSON. I think, first of all, it is a generalization that is not universally true, but it is a useful negotiating ploy.

Now, how a plan is put into effect makes a difference. If the banks were in fact unilaterally dispossesed, then clearly debt repudiation arbitrarily done would leave the countries long out of credit markets, and it would be many years, I think, before you would see much substantive bank lending.

Conversely, a solution such as in a bankruptcy or reorganization that would be a consolidation of the interests of the various stake holders will, in my view, leave an avenue for new lending that can be substantial. Some of the banks around the world I think would be back in there very quickly.

So in my view new lending would be forthcoming, and certainly that would be true for trade financing.

Senator SARBANES. Under your proposal, do you see a special or particular role for the major industrial countries, which are running large current account surpluses, and do you have any indicaton of interest on the part of these countries for participating in the kind of approach you have suggested?

Mr. ROBINSON. Very definitely I do. I think that would be a role for the United States to take up as a lead negotiator. Certainly, the Japanese in this concept of burden sharing or partnership sharing—however you choose to describe it—I know they are very much looking for ways to construct substantial initiatives. Because of their balance of payments and their interest in finding ways to

recycle their surplus, they would be prepared to take or put up disproportionate guarantees or disproportionate funding for a debt reorganization facility.

I think the same argument can be used with other surplus countries around the world, but that is a matter of government-to-government negotiation. I certainly can't conduct it. But I do know, in talking to the Japanese with whom I have been working over a period of months, some of the proposals which came from them envisioned a disproportionate sharing by them because of that fact.

Senator SARBANES. Do you have a sense that the United States is missing out on a opportunity and in fact we are ending up being perhaps in fact, and certainly perceived as—I mean, the Japanese came to the Toronto summit with a proposal. It was in effect sort of stiffed, as it were, at the summit, but you know I wonder to what extent the developing countries' perception is, well, the Japanese are in there trying to provide us with an approach that would enable us to work out of this thing, and the United States is the one that squashed the proposition.

To what extent are we being seen as the ones that are unwilling or reluctant to explore new avenues for dealing with this problem, and what does that portend in terms of the United States role as it deals with these nations?

Mr. ROBINSON. I think it is clear that we have been perceived as not wanting to embrace any program that involved government guarantees or government support, that in fact the private marketplace should work out the problem, that the features of the Baker plan were in fact successful. In certain instances the Baker plan has been successful and it very much is a necessary starting point.

But our unwillingness to go beyond that I think has served to stifle some ideas that other governments would be prepared to embrace.

Certainly, at the Canadian summit the initiative by France and Germany on the debts of the poorest countries was a step in the direction of sorting out the nonhomogeneity of the various LDC's and dealing with some of the more serious cases of poor countries in terms of their capacity to service debt. Even there they set forth options, so each G–7 country can decide how it will deal with relief as that relates to bilateral government loans. But it was a step.

The Japanese went beyond that by talking about issues, and approaches for dealing with the heavily indebted middle income countries. I salute them for their initiative in getting that on the G–7 agenda. I think, if we are to effectively deal with the G–7 agenda, it will take a leadership role from the United States to lead the huddles that seriously debate these issues. I hope that those huddles go beyond simply financial matters, because it is a trade issue and a foreign policy issue, not only for us, but also the other members of the G–7 and beyond.

Senator SARBANES. Let me just very quickly address this question. It is constantly thrown at us that this is implying a large expense and cost to the American taxpayer to move in the direction you are proposing.

As I perceive it, first of all, I think the case can be made that a large part of the funding for it should come from the current account surplus countries, which would not be the United States—in

particular, Japan and West Germany and some others—that in any event, even if the United States were involved to some degree, that if the banks take the loss on their debt because of the discount so that the debt remaining can in fact be serviced, the holder of that debt, which would be this facility with government guarantees behind it, would be at far less risk on that debt than the countries now, which would be called upon to give their guarantees now.

For instance, in our instance when you have got an FDIC backing our banks. I mean, in what way, as you envision it, would our taxpayers actually be more exposed?

It seems to me a case can be made that our taxpayers would end up being less exposed.

Mr. ROBINSON. I would agree completely. Incidentally, I think I quoted the wrong number before when I spoke of $250 billion as being the risk of the United States. That is for all banks around the world. So it is that proportion for the United States that U.S. bank exposure to LDC's is about $100 billion that is affected.

We already have a bigger exposure than we would have under an I2D2 approach. We already have a bigger exposure, whether we realize it or not or whether we accept it or not, than we would under any of the other kind of variations for funding, all of which will require G-7 type of support in one form or another.

So I look at the situation as requiring two things: one, let the G-7 governments, or those who want to participate, negotiate among themselves in terms of the share of support that they will provide.

The other negotiation is what formula for which debtor country.

Senator SARBANES. Senator Graham, any further questions?

Senator GRAHAM. Mr. Robinson, one of the consequences, it seems to me, of acting in the next 36 to 48 months, as we have in the past, is the potential that some other nation, Japan, West Germany or otherwise might step in and begin to provide the international leadership because our failure to do so has resulted in a vacuum.

What do you think of the potentials of that occurring, and what would be some of the likely consequences of it?

Mr. ROBINSON. I think the potential is clearly that we could lose some of the international leadership. We no longer have all the marbles. We no longer can dominate. But we sure can lead, and I think the world has looked to us to lead.

I believe that the next President, whoever it may be, must put this as one of their high priorities as they move into office. In fact, last Friday I was in a meeting with a group called the American Agenda—it is a kind of a poor man's National Economic Commission, and it is chaired by Presidents Carter and Ford. There were a dozen or so people there, a bipartisan group, and their charge is to come up with what the group deems to be the highest priorities that the next President will face. Then, the two Presidents will meet with the next President to convey their views.

Certainly, one of the highest priority issues that came out of this meeting was the LDC debt problem. This was with a variety of people who have been leaders in the State Department as well as in defense and in finance, who came to the conclusion that it is really one ball of wax. So, while the domestic budget deficit is pri-

ority No. 1 in everybody's book, a close second priority will be this issue of the LDC debt.

Senator GRAHAM. Thank you, Mr. Chairman.

Senator SARBANES. Jim, you have been an outstanding lead-off witness. We thank you very much, and we also especially thank you for the very careful and thoughtful work that has gone into formulating and putting forward the I2D2 program.

We are most appreciative to you for leading off these hearings.

Thank you very much.

Mr. ROBINSON. Thank you, Mr. Chairman, for you and your committee's leadership. I know that it will be one of the key players in calling the huddle as we move to that.

Senator SARBANES. Thank you.

We now turn to our panel, Eugene Rotberg, currently executive vice president of Merrill Lynch and formerly the very able and distinguished Vice President and Treasurer of the World Bank, and the Honorable Rodrigo Botero, currently visiting scholar at the Harvard Center for International Relations, covice chairman of the Inter-American Dialogue, and formerly Finance Minister of Colombia.

Why don't we start with you, Mr. Rotberg, and then go to Mr. Botero. After we hear from both of you, we will have some questions.

STATEMENT OF EUGENE H. ROTBERG, EXECUTIVE VICE PRESIDENT, MERRILL LYNCH & CO., FORMER VICE PRESIDENT AND TREASURER OF THE WORLD BANK

Mr. ROTBERG. Thank you, Mr. Chairman.

It might be useful to simply start by describing the current environment.

First, there has been, as you all know, little voluntary new lending of commercial banks to the heavily indebted LDC's over the last 2 or 3 years. Indeed, they want to sell off their loans. They don't want to increase their exposure.

From the commercial bank perspective, the conclusion is quite straightforward. They find it inappropriate that they should increase their credit risks, as Senator Graham indicated, by lending to borrowers the money needed to pay the interest. They think that is unwise and not sustainable.

The fact is that few bankers now expect to receive any of the principal on the debt of the major less developed countries. Indeed, over the last 8 years, the banking system has received but $5 billion of the $80 billion principal due. The balance has been rescheduled.

Second, for the heavily indebted LDC's the interest payments that they are now making exceed by two to three times the amount of money that is being lent to them. Those countries cannot continue to export capital to industrialized nations from poor to rich. That, too, is unsustainable.

Three, there are significant pressures in the developing world to service all debt in order simply to continue short-term trade credits to keep the country viable and, at the same time, as we all know, they have great political pressure not to service any debt, to call

for a moratorium because the debt service is, of course, a cost borne by their own domestic economies.

Fourth, at the present time the reality is that the commercial banks are gaining very substantial leverage and power in this negotiating process. The negotiations are on the issue, how much money has to be put up in any given month, 6 months or 1 year, in order for the bank to receive back the interest payment and avoid capital impairment. The banks have gained that leverage in the negotiating process because, first, the amount of their LDC debt is being reduced because they are selling off their loans to others and, second, as you know, they are reserving or writing off their loans because of the uncertain prospect for repayment.

That means in simple language that they do not now have to lend as much as they felt they had to lend 2 or 3 years ago. That event, in my view, is a destabilizing development, not a diminution of the debt crisis.

Fifth, LDC's currently make the case that much of their borrowing in the late 1970's and the early 1980's were the result of factors quite outside their control—high interest rates in the United States, falling commodity prices, deterioration of terms of trades, higher oil prices and recessions in the West. They now argue that the debt service burden is the result of external factors which are being borne by them, some of the poorest people in the world.

It is the balance between those competing forces which defines the current environment.

HOW LDC DEBT PROBLEM IS SEEN BY DIFFERENT PLAYERS

Permit me now to describe the crisis as it is perceived by the different players because each constituency typically offers a solution which is defined and fashioned to solve their particular problem as defined from their own perspective.

To the banker, the crisis is that they cannot rely on receiving interest unless they lend a good fraction of the money needed to pay it.

From the developing countries' perspective, the crisis is that what they are already paying in interest, over and above what they are receiving from the banks, comes from their work product and it is too much a burden; they perceive, quite accurately, that they are getting virtually no new money for growth or productivity. From their perspective, that is politically unsustainable.

The U.S. Treasury is also a constituency. They want to avoid the establishment of a precedent whereby the United States taxpayer, directly or indirectly, might pay for losses sustained by commercial banks. They are understandably concerned with where to draw the line, how to draw the line.

Are all banks to be provided with credit enhancement or guarantees? Is it just strong ones or weak ones, and is it for all LDC debt?

Is it just for friendly countries, unfriendly countries? Is it for LDC debt of countries who have succeeded in reshaping their economies on the way to growth, or is it credit enhancement for those countries who have failed, or who either cannot or will not make the structural changes needed in their domestic economies.

Is it to permit the exit of banks, leaving the free rider problem that Senator Sarbanes refers to, or is the credit enhancement a guarantee just for those banks who put in new money.

None of those questions have been answered.

It is also clear that it is one thing to "take care" of banks who have made loans to foreign governments as compared to those who have made loans to real estate operators, to farmers or oil producers. The latter are deemed to be part of the political fabric and the political constituency of the Nation.

Foreigners, particularly poor countries, unfortunately, are not, irrespective of their geopolitical importance to the United States.

For those having responsibility for foreign affairs, the crisis is simply that poor countries are vulnerable. They are potentially unstable, immensely complicating the relationships with those countries whose political processes are fragile at best.

For the regulatory agencies, they are concerned about the potential lack of confidence in the banking system, should the public, domestic or international, become concerned over the commercial banks' credit exposure to LDC's.

The economists are concerned typically in terms of the implications for trade, whereby the United States loses its natural markets in Latin America because those countries, locked into no growth because they receive no new funds, simply do not have the resources to pay for U.S. goods and services.

The data is available and is unambiguous as to how many jobs have been lost in the United States, how much exports have been lost, and what exports would have been had these countries been able to continue the growth of the late 1970's. It is available from the Overseas Development Council. It is available from testimony that I gave about a month ago.

And obviously, for those concerned with overall social humanitarian and health aspects, they define the crisis as one in which there is a wasting of the human spirit because there is no potential for growth, a wasting of human capacity, poorness below the level of human decency, illegal immigration across borders, and increased reliance on drug trade as the only certain cash crop.

In short, the international debt crisis is one of those issues which, in my view, will be a direct cause of political instability on our borders, the weakening of democracies, the movement of countries rapidly to the far left or right, and the increase in drug exports as countries with fragile political systems face untenable choices.

Yet I think the sad part is that none of us in this room are likely to be held accountable for not taking initiatives which would diminish the likelihood of unhappy occurrences.

Indeed, as we all know, gold stars are not awarded for taking steps whose only visible, positive effect is found in the absence of such untoward events from occurring. It is simply hard to get credit for bad events which don't happen, and it is particularly difficult to fashion a solution where risk and pain will have to be shared now and, second, it will be visible.

The problem is not made easier by the fact that no entity has been given the mandate and no entity has yet taken the mandate

to allocate that pain and risk so as to avoid what I believe will be far worse outcomes down the road.

Let me set out some objectives.

One, there is new lending to LDC's. What do I mean by new? I mean that amount which reduces the current substantial negative cash flows. It permits the servicing of debt during periods of adjustment and supports reasonable growth and facilitates trade.

It is my own personal view that the leverage for structural reform in developing countries to get those economies viable and productive, in both the political and economic sense, is facilitated by the prospect of new lending. It is not facilitated by formal debt service reduction.

The fact is that many are not now paying interest and virtually none have paid any principal in the last 8 years. Others only pay interest if a substantial portion of the interest is made available by "new" loans. That is, in a sense, also debt reduction because it lowers the amount they must generate from their own economies.

What must be implemented, I would suggest, are proposals which increase the probability of new lending as a carrot to structural fundamental reforms.

Next, LDC's remain politically viable. Whatever the solution, it doesn't prompt a collapse in the short term of fragile democratic processes in those countries.

Next, the solution is not in fact or is perceived as bailing anyone out.

And, finally, it is politically workable and practicable. That means that the accounting professionals, stockholders, legislators in industrialized countries and a broad range of the body politic in the LDC's think it is fair.

I will not describe here how that might be done. I have submitted to this committee a quite specific proposal which is designed simply to address the concerns of the various constituencies and specifically and directly meet the objectives set forth above. I must say that I have tried my best to avoid financial engineering which solves the problem only as defined by one of those constituencies but is terribly damaging to another or politically out of bounds because of its public policy implications for a third.

The heart of the proposal—and I won't go further than a few sentences—is simply to encourage new money by guaranteeing the banks par after 20 years. If they lend that new money, linked to World Bank loans, they are assured no loss on the principal, but if they exercise that right, then they must relend the proceeds back to the World Bank and receive for the succeeding 20 years the 3 month Treasury bill rate—an opportunity loss which has far different accounting consequences from discounting paper.

It doesn't take any great wisdom to implement techniques which would cushion commercial bank losses. It doesn't take any great expertise to protect them from further losses on their lending to LDC's, although some of those measures undoubtedly would raise politically significant public policy concerns.

It is more difficult, however, to fashion an initiative absent saying, banks, you are protected, which would encourage them voluntarily to lend the money. That is more subtle, as it involves fac-

tors relating to pressures on banks from their stockholders, their boards, and their long-term strategy.

But the most difficult dilemma, I think, is to fashion an initiative which would encourage the developing countries to make fundamental structural adjustments in their economies with the prospect that by so doing funds later will be forthcoming and investment and savings would increase.

I am sure that Mr. Botero will refer to the Colombian experience and the experience of several other countries in Latin America who have made structural reforms, who have made painful changes, and have received no new money.

From the LDC perspective, the current payment, the belt tightening is only worth it if they are going to get new money later. From their perspective politically, that conclusion is uncertain.

NOTHING HAS BEEN PUT IN PLACE TO SOLVE LDC DEBT CRISIS

Their political systems in the meantime are fragile, the attitude of the external world to the positive steps they might take is unknown.

We might ask ourselves how come the debt crisis hasn't been solved in 8 or 10 years. A lot of people think it is important politically, financially, and economically. A lot of extremely bright people have been working on it. It is considered important to virtually every sector of our economy, yet somehow nothing is put in place.

It is not because of lack of motivation and certainly not because of lack of care and not for lack of intelligence. I suspect that the reason, in part is that there is a great debate, which is sometimes not articulated, whether it is in the best interest of the LDC's simply to reduce their debt service obligations one way or another, which in my own personal view would substantially discourage commercial bank lending. It would force LDC's to come to grips with an extremely difficult domestic environment. They would have to work their way out of a period of negative growth until their domestic economies would be able to attract new external inflows. The fact is that many developing countries prefer that. It is politically quite attractive to them to point to a moratorium, point to a reduction in debt service to their domestic constituencies.

The alternative approach is to forge links, explicit links between the banks, the industrialized countries, the LDC's, and the international lending agencies, which would encourage explicitly new private lending while at the same time avoiding the potential pitfalls implicit in providing directly or indirectly what is of concern to the U.S. Treasury—and what will always be of concern to any U.S. Treasury or to any central bank—namely the potential moral hazard of providing safety nets or credit enhancement for the private sector for their past decisions.

So there is a great debate. Which is better? We endlessly debate. Meanwhile the countries in Latin America become more volatile, become poorer.

I personally opt for that school which would not put LDC's in a "sink or swim" category. In my view, it is simply too dangerous.

We see what has happened in Mexico. We do not yet know what is going to happen in Argentina.

I would suggest initiatives which have a high probability of encouraging new commercial bank lending. The specific proposal that I have submitted is designed to protect the World Bank and the U.S. Government from the moral hazard and the financial risk and the political backlash arising from the allegation that commercial banks were somehow being bailed out or that it involves putting more good money after bad.

Whether the proposal before you is the best one is really unimportant. There are lots of superb proposals. There are many variations and many subtleties.

What is important is to recognize the situation in Latin America is not sustainable over the next 36 or 48 months. The fact is, though it is sometimes difficult to admit, that this stuff goes beyond finance. It relates to the viability of nation states which are very close to us.

Right now our neighbors, tens of millions of people, in fact feel hopeless, with little positive prospect for the future or a sense of expectancy.

That is not a healthy environment anywhere, let alone on our borders.

Let me summarize in one sentence.

What must be done is the implementation of initiatives which are explicitly designed to break the impasse which now exists between the U.S. Government, the commercial banks, the developing world, the multinational entities, and the regulatory agencies.

I am convinced that it can be done and must be done. Thank you.

[The complete prepared statement of Eugene H. Rotberg follows:]

Testimony of Eugene H. Rotberg
before the
Subcommittee on International Finance
and Monetary Policy
of the
Committee on Banking, Housing and Urban Affairs
United States Senate
August 2, 1988

It might be useful first to describe the current environment faced by the heavily-indebted developing countries.

- There has been little new lending from commercial banks to the heavily-indebted LDCs over the last two or three years. Indeed, they want to sell off their loans -- not take on increased exposure.

- For most LDCs, their interest payments alone exceed by two to three times the amount of money being lent to them. This means there is a transfer of resources from poor to rich.

- From the commercial bank perspective, however, they find it inappropriate that they should increase their credit risk exposure by lending the borrowers the resources needed to pay back the interest. They consider that unwise and unsustainable.

- As a result, there is little new external private resources flowing into the LDCs for building their infrastructure, or to sustain economic growth. Clearly, however, the developing world cannot export capital to industrialized nations. That, too, is unsustainable.

- There are political pressures in LDCs to service all debt in order simply to keep the country viable and creditworthy, at least for short-term trade finance -- and there are great political pressures not to service debt, the costs of which are borne in their domestic economies.

- Banks are gaining leverage and power in the negotiating process, i.e., how much "new" money must they lend in order to assure they can continue to receive interest income and avoid capital impairment. Banks have gained leverage because first, the amount of their LDC debt is being reduced as they sell off their loans to others; and, second, they are provisioning or writing off the loans because of the uncertain prospects for payment.

- Despite the increasing leverage of the commercial banks, they are not yet out of the woods. The fact is they cannot readily take the losses which would be made explicit if they decided not to lend anything to help reduce the interest rate burden. But even if they took those losses, it would, in my view, be a destabilizing development, as it would virtually

assure that there would be no money made available thereafter for a protracted period of time.

- LDCs make the case that much of the borrowings in the late '70s and early '80s were the result of factors outside of their control: high interest rates in the U.S., falling commodity prices, deterioration of terms of trade, higher oil prices, and recessions in the west -- factors which made it impossible for them to properly conduct their internal domestic economic affairs. And they argue, now, that the debt service burden as a result of those external factors are being borne by them -- some of the poorest people in the world.

Permit me now to define the debt crisis -- or, rather, describe the crisis from the perspective of the different players. For the reality is that the concerns of a very diverse constituency have resulted in a paralysis of action as each constituency offers or rejects "solutions" to a problem defined usually only from their own perspective.

- To the banks, the crisis is that they cannot rely on receiving interest unless they lend a good fraction of the money needed to pay it.

- From the developing countries' perspective, the crisis is that they already are transferring large amounts of hard

currency from their work product -- their exports -- to international banks outside their country and are getting little new money for growth or productivity.

- From the U.S. Treasury perspective, they want to avoid the establishment of a precedent whereby the U.S. taxpayer, directly or indirectly, pays for losses sustained by banks. They are understandably concerned with how or where to draw the line -- are all banks provided with credit enhancement or guarantees? strong ones? weak ones? Is it for all LDC debt or just for friendly countries? For those who are trying to restructure their economies or those who can't or won't? Is it to permit the "exit" of banks, or only in connection with banks who supply "new money?" While legislators may provide support or protection for financial institutions who have made unwise loans to farmers, real estate operators, energy producers, these institutions are deemed political constituencies. Not so for developing countries -- irrespective of their geo-political importance or the U.S. self interest.

- For those having the responsibility for foreign affairs, the crisis is simply that poor countries are vulnerable and potentially unstable, immensely complicating the conduct of our relationships with those countries, whose political processes are fragile, at best.

- For the regulatory agencies, the crisis is reflected in their concern over the implications of a lack of confidence in the banking system should the public -- domestic and international -- become further concerned over the banks' credit exposure to LDCs.

- For economists, the crisis is typically defined in terms of its implications for trade, whereby the U.S. loses its natural markets in Latin America because LDCs, locked into no growth, do not have the resources to pay for goods and services.

- And for those concerned with overall social, humanitarian and health aspects, they define the crisis as one in which there is a wasting of the human spirit because there is no potential for growth, a wasting of human capacity, poorness below the level of human decency with all that portends, illegal immigration across borders, and increased reliance on drug trade as the only certain cash crop for export.

I can think of no public policy issue which deserves greater attention than the international debt crisis, and yet, probably because the definition of the problem comes from so many different constituencies, often in conflict with each other, it is little wonder that a "solution" is not forthcoming. The international debt crisis is one of those issues which, in my view, will be a direct cause of political instability, the weakening of

democracies, the movement of countries to the far left or right, the increase in drug exports -- as countries with fragile political systems are faced with untenable choices for their future. And yet, none of us here are likely to be held accountable for not taking initiatives which would diminish the likelihood of such unhappy occurrences. Indeed, as we know, gold stars are not awarded for taking steps whose only visible positive effect is found in the absence of such untoward events from occurring. It is hard to get credit for bad events which don't happen. And it is particularly difficult to fashion a solution when it is not likely to fully satisfy everyone where risk and pain will have to be shared and where it will be visible. The problem is not made easier by the fact that no entity has been given the mandate to allocate that pain and risk so as to avoid far worse outcomes down the road.

I have said before that a "solution" must deal with the honest concerns of the various constituencies. And the shared pain cannot be so high, either in quantitative terms, or in terms of appropriate public policy, that it will be rejected by any one of the powerful players. New initiatives must be subtle enough so that although there is risk and pain, it is not of a type or a magnitude which should cause any of the players to withdraw support.

I believe it is useful to set out some objectives:

- There is new lending to LDCs. By "new," I mean that amount which reduces the substantial negative cash flows, permits servicing of debt during periods of adjustment, supports reasonable growth and facilitates trade.

- LDCs remain politically viable. Whatever the "solution," it doesn't prompt a collapse of fragile democratic political processes in the country.

- Banks can continue to attract capital, with the prospect of earning a reasonable return, and can continue to diversify their activities with broad-based support for their own funding activities.

- The "solution" is not, in fact, nor perceived as, bailing anyone out.

- It is politically workable/practicable. That means accounting professionals, stockholders, legislators in industrialized countries, and a broad range of the body politic in LDCs find it fair.

I will not describe here how that might be done. I have submitted to you a specific proposal which involves a realistic assessment of what is workable within the context of the above objectives. I have sought to avoid financial engineering which solves the

"problem" as defined by one of those constituencies, but is quite damaging to another, or politically out-of-bounds for a third.

The fact is, it takes no great financial expertise or wisdom to implement techniques which would cushion commercial bank losses, or protect them from further loss on their lending to LDCs -- though some of the measures, undoubtedly, would raise political as well as significant public policy concerns. The techniques and methods are available. It is more difficult, however, to fashion an initiative (absent protecting banks from loss), which would encourage them voluntarily to lend new money. That is more subtle as it involves factors relating to pressures on banks from stockholders, boards of directors, regulatory agencies and, indeed, the long-term strategy of the commercial bank itself.

But the most difficult challenge is to fashion an initiative which would encourage the developing countries to make difficult structural adjustments in their economies with the prospect that by so doing, new funds would later be forthcoming and investment and savings would increase. From their perspective, the results of "belt-tightening" are quite uncertain. Their political systems are fragile and the attitude of the external world to the positive steps they might take is, in fact, unknown. Indeed much of the debate on debt crisis initiatives centers around the difficulty of knowing whether it is best -- in the best interest of LDCs -- to reduce LDC debt service obligations which, in my view, would thereby discourage any commercial bank lending, forcing the LDCs

to come to grips with a very painful immediate environment. They would then have to work their way out of a period of negative growth until their domestic economies, without outside support, became sufficiently attractive to encourage new external inflows and investment. Indeed, many LDCs prefer that approach for it is politically quite attractive to point to moratoria or debt service reduction to domestic constituencies. The alternative approach is to lend new resources now and to forge links between the banks, the LDCs and the international lending agencies, which would encourage new private lending while avoiding the potential pitfalls implicit in providing, directly or indirectly, some form of safety net or credit enhancement to the private sector for their new lending.

There is uncertainty and debate as to which approach is the wisest one. We, in western countries, endlessly debate the challenging alternatives. Those in Latin America, however, become poorer and more volatile in the interim.

I personally opt for that school which would not put LDCs in the "sink or swim" category. In my view it is too dangerous an alternative. Rather, I would suggest initiatives which have a high probability of encouraging new commercial bank lending.

The proposal I have suggested is designed to protect the World Bank and the U.S. government from the moral hazard, the financial risk and the political backlash arising from an allegation that

commercial banks were being bailed out or that it involves putting more good money after bad. But whether the proposal before you is the best one is really unimportant. What is important is to recognize that the situation in Latin America is not sustainable. The subject we discuss here goes beyond finance; it relates to the viability of nation states which are quite close to us. Once that is recognized, I expect that reasonable people will address initiatives which have the highest probability of success. I define success as that which avoids political instability in LDCs and facilitates a sense that people feel that their lives are worth living with a prospect of growth for themselves and their children. That is not the case now and, in my view, it is the fundamental proof of the existance of a debt crisis as our neighbors -- tens of millions of people -- feel hopeless, with little positive prospect for the future or a sense of expectancy. That is not a healthy environment anywhere -- certainly not on our borders. Let me summarize in one sentence: What must be done is the implementation of initiatives which are specifically designed to break the impasse which now exists between the U.S. government, the commercial banks, the LDCs, the multi-national agencies and the regulatory agencies. I am convinced that can and must be done.

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Toward A Solution To The Debt Crisis

By

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My purpose today is to identify the players, the pressures, and to suggest a "solution" to the debt crisis that addresses the concerns of a diverse constituency of involved parties. It is assumed as a *sine qua non* to any proposal a country-specific, wise economic development strategy and a healthy world economy. It is also assumed that no piece of financial engineering or sharing of risk can be cloned onto an unworkable political economy. Furthermore, my thesis is also based on the premise that the financial engineering that addresses primarily the means to "write off" LDC debt in a fashion acceptable to banks, without providing for or facilitating new lending, is of doubtful significance. Indeed, while rhetoric may label such developments as "at least a beginning," I believe it is basically counterproductive to increasing the new flows that are so necessary for development and productivity, and so fundamental to encourage the discipline needed for domestic macroeconomic changes.

It may be useful first to summarize what happened in the 1970s and early 1980s, for that background is relevant to defining the problem and providing a frame of reference for its solution.

Why Did Commercial Banks Lend to LDCs?

- Governments were pressuring, or at least encouraging, banks to recycle OPEC financial surpluses. They did so — to LDCs.

- There was little other investment for OPEC financial surpluses. Clearly banks could not buy U.S. Treasury Bills at 2% less than their marginal cost of attracting deposits.
- There had been little previous "pain." All "foreign" debt in recent memory had been serviced.
- General purpose or balance of payment loans were made on the assumption that commodity prices would at least rise at the level of inflation and governments would generate sufficient foreign exchange from traditional exports to service their debt.
- Herd instinct — a desire for market share. Japanese banks were moving to London and creating competition at narrow spreads. It was a borrowers' market, with little distinction drawn on the basis of perceived credit standing.
- The loans were syndicated to non money center banks — often the so-called regional banks anxious to participate in international business and affiliate with a rapidly expanding distribution network outside the United States.
- The dread factor — the loss potential was so severe, given the magnitude of the lending, that little attention was given to the uses of the funds or the development program of the borrowers.
- Central Banks, it was assumed, would always be there as a lender of last resort. In short, the financial system would be safe so long as the obligations remained on the books of commercial banks.

It was a scenario that lasted for a decade — one in which risk exposure increased, credit standing deteriorated, with no market mechanism in place to price risks or value the portfolios. Now, after years of ad hoc negotiations, reschedulings, provisioning, confrontations, interruption in debt service, a reassessment is taking place — part of a continuing process as each of the constituencies seeks to protect its interests. What are LDC prospects for servicing debt?

It is a truism bordering on a cliché that each country must be examined individually, that solutions must be tailored to the demands and requirements of each country, that fatigue is likely to make us hostage to extremism. Nonetheless, I would hope there is room for some straight talk. Most heavily-indebted LDCs are not likely to repay principal in the foreseeable future. I suspect that virtually all principal falling due in the next five years, and probably longer, will be rescheduled or refinanced. The difference, however, between repaying and not repaying principal over a long period — *assuming* interest is paid — is but a few basis points. The issue is perhaps better put: Can LDCs service their debt with a reasonable degree of certainty and maintain modest growth — without money packages equal to a substantial fraction of their interest rate obligations? I think not. Unfortunately, based on recent experience, I assume that over the next several years, the amount of net new lending of commercial banks will not come close to the interest payments due to those institutions. To the extent that loans are sold in the market at a discount from par, that market price will measure and reflect the impact of the banks' decision not to continue to lend new funds to facilitate payment of interest.

Commercial Banks: A Constituency

I assume that, during periods of stress (protectionism, whose effect, relatively, is considerably greater on LDCs than on industrialized countries; recessions in the West; escalating interest rates), we will see interest rates for LDC debt set below market rates, prepayments by industrialized countries for major LDC exports, and conversion of loans to bonds at discounts from par with selective credit enhancement. On the other side, as banks begin to sense leverage and power, I expect that interest will be paid, even without new lending, if pressures develop to withdraw short-term export financing and trade credits unless full interest payments are made on the stock of outstanding debt.

It is in this context that commercial banks' leverage might be addressed.

Mostly, for understandable reasons, they want out, and as close to par as possible. They want to reduce their exposure and certainly do not want to increase their risk, even if by so doing the loans are deemed "current." Understandably banks would like others to assume or purchase old loans at as high a price as possible and guarantee that debt service on new credits will be credit risk free. They look for a nod to some creative accounting, a relaxation of regulatory pressures and for ways to "spread out" the loss over a period of time. Banks, in short, want increased leverage. They may, moreover, be well on the way to achieving it from the substantial reduction of LDC exposure to their capital, from the fact that some have already provisioned against the loans — from sales of loans or swaps — and from recent financial engineering, which permits them to delay, mask or amortize their losses over time. These developments, I would argue, remove the pressure to lend. Moreover, from an LDC point of view, it reduces the pressure to make painful macroeconomic change as the LDC realizes that "new" money is not likely to be forthcoming. But, at the same time, as a political exigency, LDCs will, from time to time, seek to benefit from a perceived "loss capacity" in the banks, which they seek to convert into some form of short-term debt relief.

Nonetheless, while financial engineering and provisioning can reduce the pressure to reschedule or supply funds, the need to receive interest remains. I suspect that the present value of that projected interest stream has not been fully discounted from the market price of LDC debt. Stated another way, the market price of LDC debt so far primarily reflects the potential loss of principal at maturity, not the risk of nonpayment of interest if unaccompanied by lending to make those payments.

Without a reasonable certainty of debt service, the prospect for "securitization," I would argue, is not positive because, basically, it is a method to arrive at an accounting result, and cannot fairly be said to address the debt problem unless that problem is defined quite narrowly, i.e., how to report commercial bank earnings. Certainly at some price LDC debt can be repackaged and sold, but for a number of reasons, I do not believe it will be meaningful.

(1) As noted, the amount of provisioning or write-offs reflects primarily the probability that a portion of the principal will not be paid. It does not reflect market value as it does reflect the assessment of the risk of nonpayment of interest to the new buyer. Buyers do not expect to have to put up new money to receive interest on their discounted purchases. Nor do they expect to have to share, pro rata, any interest received with those who did not assign or sell their loans.

(2) Switches into equity for large money center banks are not likely to be substantial. The equity markets are small in the context of the amount of debt outstanding. In any event, there are considerable political considerations — particularly if the equity is in basic industry, raw materials, commodities or minerals. It smacks of colonialism and is fraught with future political uncertainty. Debt for equity swaps with local counterparties are more acceptable, but are not likely to be substantial in volume.

(3) Regulatory agencies should be troubled by moving debt from banks into institutions over whom they have little control — pension funds, insurance companies, speculators or buyers of "junk bonds" — who can precipitate a much different, less predictable and more volatile financial scenario if debt is not serviced. These buyers do not reschedule. It is not likely they will be as malleable as commercial banks when it comes to providing new money packages for the good of the "financial system." Of course, if non bank holders of securitized paper were placed in a preferential or collateralized position, a development which would reduce the probability of their triggering a default, it assuredly would be counter-productive to facilitating the new bank flows needed for growth. Conversely, while a piece of financial engineering might be implemented that would, in effect, subordinate the claims of the new securitized buyers to the old holders or to those who provided new funds, that would make the paper somewhat difficult to sell, to say the least.

(4) The loans themselves are evidenced by complex legal agreements whose provisions significantly affect the rights of assignees of the creditors. These provisions generally are not yet well known.

(5) LDCs that are not now servicing debt unless accompanied by new flows cannot be assumed likely to service contractual debt issued at par, at a rate of say, 9% where the new purchaser has purchased at a discount resulting in an effective yield of 18% — a speculative investment by a party who did not provide the funds to the LDC in the first place. If there is a loss to be borne by banks, LDCs will likely require that the corresponding gain be theirs in the form of lower debt service on the securitized asset — not a potential gain to a new buyer. Clearly, the LDC has the leverage to prevent that gain.

(6) And, finally, I doubt whether major banks can take the income hits which would be explicitly recognized upon resale or assignment of their holdings at prices reflecting the debt service risks — assuming the paper can be sold within the existing legal framework.

The LDCs: A Constituency

There are political pressures to service debt and pressures not to. Factions both in and out of power in developing countries find many solutions unacceptable, particularly those which contemplate full debt service linked to the highest marginal cost of funding in a currency over which they have no control. Those costs are borne by poor people often living at the margins of existence in countries with fragile political systems.

There are, nonetheless, also significant pressures to service debt in order to obtain new capital for high priority projects and to maintain even modest growth. Exports must be financed, ...ustries retooled, infrastructure put in place and short-term export credit financing maintained.

If an LDC does not service debt, those short-term credits are at risk. If these are not maintained, the country shuts down. Thus, LDCs, too, are under painful pressures, facing basic choices that affect their viability as sovereign nation states.

The choices are not easy ones. From their perspective, a not insubstantial part of the problem in the past, and even now, lies outside their borders and relates to matters over which they have no responsibility and little control.

(1) Protectionism in the West has hurt. It has made it difficult to export, earn dollars and service debt.

(2) High real dollar interest rates have increased their costs and their capacity to grow. And over the last year, nominal rates have fluctuated more than 250 basis points, with prospects of higher costs as market participants — increasingly non-U.S. — rethink how, where and at what cost they should maintain their investments in U.S. dollars.

(3) Sluggish growth in the West has reduced the demand for their products. A recession in industrialized countries would immediately shut off their capacity to earn the necessary foreign exchange to service debt.

(4) A deterioration in terms of trade from a wide variety of circumstances in the 1980s produced falling commodity and mineral prices for exports and, more recently, the rising costs of European and Japanese imports in U.S. dollar terms have reduced the generation of foreign exchange to service debt.

Heads of state in developing countries look upon these external matters, essentially outside their control, as seriously affecting their financial and political capacity to pay. They are asked, nonetheless, to increase the pressures on their domestic society to service debt to money center banks. It is naive to assume that these pressures are painless or irrelevant. It is not useful to simply argue "a deal is a deal, you should have thought about it when you borrowed the money in the first place."

Industrialized Countries: A Constituency

They want to avert a financial crisis in which commercial banks cannot raise equity capital or are considered questionable credit risks. That would seriously damage their influence as international powers.

Senator SARBANES. Mr. Rotberg, thank you very much for an extraordinarily thoughtful statement.

Mr. Botero.

STATEMENT OF RODRIGO BOTERO, VISITING SCHOLAR, HARVARD CENTER FOR INTERNATIONAL RELATIONS, CO-VICE CHAIRMAN, INTER-AMERICAN DIALOG, FORMER FINANCE MINISTER OF COLOMBIA

Mr. BOTERO. Thank you, Mr. Chairman, Senator Graham.

The heavily indebted countries of Latin America and the Caribbean are in their sixth year of an economic crisis that has caused unprecedented hardship for the region. Because of its long duration, the magnitude of lost output, and the high social costs involved, the crisis has been more severe and painful than the Great Depression of the 1930's.

The region's economic problems are closely linked to the rapid buildup of foreign debt that took place during the past decade, to the terms under which the commercial debt was contracted, and to the uses to which the internal resources were assigned.

Excessive borrowing during the 1970's postponed required adjustments to external shocks, allowed the continuation of inward looking import substitution development strategies, and temporarily covered the consequences of fiscal laxity and exchange rate mismanagement.

A heavy price has been paid by these mistakes. The region is faced with the need not only to cope with that crisis but also to bring about structural reforms to correct past distortions and to adjust to the shocks of a rapidly changing world economy.

The decade of the 1980's has been lost in terms of overall economic development. Per capita output at the end of 1988 in Latin America and the Caribbean will be at the same level it had reached in the late 1970's. The rate of inflation and unemployment will be higher. Interest payments on the foreign debt are now equivalent to 4 percent of the region's output.

From 1982 through 1987, Latin American countries have sent abroad some $240 billions to service their debts, approximately $120 billion more than they received in new credits.

Imports have been reduced drastically, and governments have had to curtail investments in social programs. Real wages have decreased. In some countries the rate of investment is insufficient to maintain the existing capital stock.

The debt crisis has coincided with a period of democratic renewal in Latin America. Several of the largest debtor countries are having simultaneously to manage an economic crisis and the process of political democratization.

The remarkable aspect of the debt crisis so far is the commitment of democratic governments in the region to remain within the existing international framework and to fulfill external obligations at a high political cost. This commitment should not be taken for granted. A sustainable strategy for dealing with the debt crisis will have to be formulated within the constraints of democratic policymaking in the hemisphere.

NEED FOR CONCERTED ACTION

One of the lessons provided by the experience of the past 6 years is the need for concerted action by all the participants in the debt crisis if lasting progress is to be achieved.

The major actors, the governments of creditor and debtor countries, the commercial banks, and the multilateral organizations, all view the problem from different perspectives, respond to different constituencies, and are driven by different motivations. But a constructive solution to the problem must allocate costs and benefits among the relative actors in an equitable manner.

The common shortcoming of unilateral schemes is that they tend to assign all or most of the costs to others, while they seek to reap most of the benefits.

A concerted action on the part of such a heterogeneous group of participants will require strong leadership from the principal industrialized country Governments: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States—also known as the G–7 members.

If the international financial community is going to move from the present strategy of "muddling through" to a comprehensive treatment of the debt crisis, the United States particularly will have to provide the initiative. Given its role in the world economy, its voting power in the multilateral financial organizations, and the exposure of U.S. commercial banks in this hemisphere, any policy innovation toward developing country debt will require vigorous and sustained political leadership on the part of the United States.

During the past 6 years there have been several instances of constructive and decisive intervention by the Federal Reserve and the Treasury Department to avoid the breakdown of specific negotiations or to bridge financing for troubled debtor governments. But these sporadic crisis management actions have come about as short-term responses to an emergency rather than as part of a systematic, long-term initiative.

Treasury Secretary Baker's proposal of October 1985 to change the focus of the debt strategy from austerity to growth was a step in the right direction. However, the financial flows that were to be provided by the commercial banks on a voluntary basis according to the Baker proposal did not materialize.

The heavily indebted developing countries will not be able to resume economic growth if the international financial community imposes on them a scheme whereby they remain exporters of capital to the industrialized countries.

The present strategy toward the debt problems of these semi-industrialized developing countries does not seem sustainable as it affects Latin America. The commercial banks are trying to reduce their exposure in the region, and the multilateral financial organizations are now receiving more in amortizations and interest from existing loans than what they are providing in new disbursements.

As economic and social conditions continue to deteriorate in the major debtor countries, the costs of complying with the existing rules are escalating. From within the governments but particularly from the opposition groups, pressure is mounting in favor of a

more aggressive negotiating posture vis-a-vis the international financial community.

A concerted solution to the debt crisis which allows for renewed growth and economic reform in the heavily indebted developing countries as well as the financial stability of the commercial banking system would have to incorporate the following elements:

One, there should be a significant increase in the level of official flows of long-term financial resources from the World Bank, the Inter-American Development Bank, and the Export-Import Bank. In cases requiring balance-of-payments support or a monitoring role, the International Monetary Fund should also be able to increase its level of financing.

Two, the debt service burdens of some countries will have to be reduced. The magnitude of the reduction should be sufficient to allow for a rate of gross national product growth on the order of 5 percent a year.

This reduction should be contingent on the adoption of an economic reform program by the government of the participating country which would encourage private investment, foreign as well as domestic, raise overall productivity, and improve export performance.

Three, a mechanism is needed for providing partial compensation to the commercial banks for the effects of the debt service reduction and for keeping them involved in trade financing and other short-term operations with the developing countries. This would almost certainly imply some form of asset substitution arrangement directly supported by the governments of the industrialized countries or guaranteed by those governments through a newly created facility.

Alternatively, the asset substitution scheme could be managed by existing multilateral financial organizations backed by guarantees from the industrialized country governments. Participation by the commercial banks would have to be voluntary. However, a well-designed system of incentives and disincentives could bring about widespread participation.

The existing debt strategy does not incorporate these three elements. The multilateral financial organizations are playing a marginal role in the process of restoring sufficient long-term capital flows to the region. Meanwhile, the debtor countries as well as the commercial banks are finding greater inducements to behave in a noncooperative manner.

The present framework of managing the debt crisis is fragile. It is vulnerable to shocks from policy changes in the major debtor countries. More than 40 years ago of this Nation's most distinguished statesmen, Secretary of State George Marshall, spoke about a troubled region of the world as follows:

> The farmer has always produced foodstuffs to exchange with the city dweller for the other necessities of life. This division of labor is the basis of modern civilization. At the present time it is threatened with breakdown. The town and city industries are not producing adequate goods to exchange with the food-producing farmer. Raw materials and fuel are in short supply. Machinery is lacking or worn out. We cannot ignore the factor of time involved. Disintegrating forces are becoming evident. The patient is sinking while the doctor is deliberating. So I believe that action cannot await compromise through exhaustion.

George Marshall was referring, of course, to conditions in Europe in 1947. But his words seem quite appropriate to describe the situation that many countries of Latin America and the Caribbean face today.

Thank you.

[The complete prepared statement of Drodrigo Botero follows:]

They want to mitigate an economic crisis in which the underpinnings of government in LDCs, fragile at best, is hostage to an untenable choice: To meet all debt service in the context of no growth, with the resulting transfer of wealth from poor to rich, which is not sustainable politically or, conversely, to default, which would, in turn, eliminate external inflows and increase flight capital because of the absence of resources for infrastructure and development.

They want to avert a political crisis. The politics — the concern for democracy and/or stability — is primarily a Congressional, Parliamentary one as well as one of considerable concern to foreign ministries. But the fact is these constituencies, while potentially powerful players, are not direct participants, and are ambivalent in their attitude and response to a problem in which domestic constituencies may have little concern for money center banks which have lent to "foreign" states that "dump" products in the markets of industrialized countries.

While industrialized countries clearly want strong banks, they are not prepared to send a bailout signal to domestic financial institutions, except for very special constituencies. A U.S. Congress, for example, will take steps to support thrift institutions that provide finance for residential mortgages or for farmers. Not so for poor countries.

And, money center banks are not a beloved constituency in a populist society. They do not have the support for broad-based legislative action which might be perceived as holding them harmless, directly or indirectly, for imprudent lending, particularly to "foreigners." That type of support is probably politically unacceptable. It will be categorized as a "moral hazard" — a perfectly fair label selectively used, rationale for not obligating governments for the mistakes or failures of the private sector. Indeed a World Bank capital increase will likely be under quite close scrutiny as a substantial body of legislators in the United States will contend — and I believe without justification — that it would serve to "bail out" the banks, while others will contend that no capital increase is justified unless the bank uses its powers to "alleviate" the debt crisis.

Despite the lack of political support, however, industrialized countries also know they need economically strong LDC markets for their goods and services — so fundamentally necessary as a means of reversing trade deficits and facilitating the opening up of new markets.

The Multinational Banks: A Constituency

The question has often been put: Why don't multinational lending institutions address the problem through use of their guarantee power or simply lend more? Because Congresses and Parliaments are not likely to let those institutions do indirectly what governments will not, or cannot, do directly. Because governments will find it quite difficult to draw the line, as a political matter, as to who is "entitled" to guarantees, under what circumstances, and how much.

Furthermore, international institutions are not primarily financed by governments. They are owned by governments. It is useful to recall who would be put at risk. The World Bank, for example, is owned by governments. These stockholders, however, have contributed but $5 billion of a $100 billion plus balance sheet. The great majority of the balance comes from bondholders — the private sector — who lend to the Bank. These investors in long-term fixed-rate bonds of the highest credit standing, issued in the tens of billions of dollars by the World Bank, do not presently lend on fixed term to commercial banks. They do not expect the World Bank to assume the risks taken or to be taken by commercial banks. Nor do they contemplate that the protection provided by callable capital, designed to protect them in the event of adversity, would be rechanneled or diluted in favor of commercial banks, which have far greater exposure than does the World Bank. But they would be prepared to support policies which leveraged the World Bank's capital if those policies encouraged new private financial flows, increased conditionality and thereby, overall, made the Bank a stronger institution.

Finally, multinational lending institutions are not likely to provide credit enhancement, directly or indirectly, except as part of a package to provide new funds linked to fundamental structural adjustment of LDCs designed to facilitate

growth and development. And, of equal importance, they are likely to look to a certainty of private funding should those guarantees turn out badly, as will governments which provide support in the form of "callable capital," also look to the private sector as a funding source before a call on their capital is triggered.

A brief recitation of the concerns of the various constituencies suggest some reasons why no "solution" has been forthcoming:

(1). Each constituency seeks to protect itself and shift pain elsewhere. Negotiating postures are hard and visible.

(2). Each constituency has significant power, but insufficient to dictate even the question to be addressed, let alone the power to assure its resolution. The LDCs do not have the leverage or power to encourage sufficient lending to facilitate growth.

(3). There is no mandate from either governments or the private sector to official institutions to act as a broker in the dialogue between the constituencies. Official institutions cannot prudently bring much to the table. They can say "lend" to one constituency, "adjust" to the other. They have not as yet been vested with much more practical authority. And they are, correctly, quite concerned with their credit standing and financial viability.

(4). There is little common awareness of the constraints on official institutions, i.e., their constituencies.

(5). And finally, a "solution" is typically seen as one in which everyone comes out whole, risks and pain are avoided, and losses are borne by someone else. These kinds of proposals do not get off the ground. They are either fantasies or modestly relevant. As are those which simply allocate and quantify the loss by unilateral fiat. Most "solutions" to date seek not to balance risk, but to avoid it; not to share pain, but remove it; not to mask or delay loss, but eliminate it; not to confront reality, but deny it. They are, in short, politically unworkable.

It may be useful to set out some objectives for what I mean by a "solution":

- There is new lending to LDCs. By "new," I mean that amount which stems substantial negative cash flows, permits servicing of debt during periods of adjustment, supports reasonable growth and facilitates trade.
- LDCs remain politically viable. Whatever the "solution," it doesn't prompt a collapse of fragile democratic political processes in the country.
- Banks continue to attract capital, with the prospect of earning a reasonable return, and can continue to diversify their activities with broad-based support for their own funding activities.
- The "solution" is not, in fact, nor perceived as, bailing anyone out.
- It is politically workable/practicable. That means accounting professionals, stockholders, legislators in industrialized countries, and a broad range of the body politic in LDCs find it fair.

I earlier noted that there was no quick fix through financial engineering. Wise development programs are a *sine qua non* for progress. Nonetheless, I would contend that financial engineering which has as its purpose not the creation of an accounting effect, but rather the establishment of a politically workable structure that can be accepted by diverse constituencies is useful and productive. Specifically, I believe a "solution" in the context of the foregoing is likely to be one in which there is a sharing of present pain for delayed, contingent and "spread out" opportunity losses. It would be designed, fundamentally, to increase the comfort level of commercial banks and provide a sense of equilibrium of risk-taking amongst the constituencies. Each constituency would take risk — but not the same kind of risk, nor at the same time.

A solution should attract new money without sending unwise signals and have political support in both industrialized and developing countries. The proposal below is designed to address these objectives. It does so by defer-

ring certain commercial bank risk and moving it to potential opportunity losses with a delayed and contingent liability supported by a potential involvement of public institutions.

I have the following proposal:

- A commercial bank (Bank) lends new money to, say, Brazil equivalent to a substantial fraction of interest due to them, for twenty years based on a tranched and conditioned World Bank structural adjustment loan. The principal repayments are amortized, but with a substantial "balloon" after twenty years.
- The World Bank (IBRD) provides a put at par on all principal payments to the Bank, exercisable only after twenty years. The principal risk, therefore, is credit risk free.
- Assume that the Bank, after twenty years, exercises the put and receives par from the IBRD in exchange for the notes due from Brazil.
- The Bank is then obligated to simultaneously re-lend the same amount to an IBRD affiliate, which immediately repays IBRD and purchases for its own balance sheet the loans to Brazil. The Bank would receive the three-month T-Bill rate for the succeeding twenty years from the IBRD affiliate. Effectively, the Bank has switched its credit exposure from Brazil to an IBRD affiliate — a premier credit in the framework of a 40-year loan.
- The IBRD affiliate now has Brazil on its books.

The Bank has a "risk free" principal asset on its books because of the put to IBRD. The IBRD and its capital base will support the put just as any other obligation of the IBRD.

The Bank's protection for receiving T-bill-based interest from the IBRD affiliate is derived from the strength of the affiliate.

- An initial substantial IBRD investment — perhaps in part funded by the paid-in component of the next IBRD capital increase, and/or an investment by IBRD from its liquidity, and possibly an investment by commercial banks.

- Investments of such resources for twenty years in, say, U.S. government 20-year zero coupon bonds, during which period there would be no call on the affiliate's resources.
- A fee, for the put, for twenty years from the Bank.
- The spread between the cost of borrowing to the affiliate (should it choose to do so) and reinvestment of the proceeds in the credit markets.
- The spread profit over the three-month T-Bill rate provided to the Bank on the loan to Brazil after twenty years.
- A lender of last resort facility or a rediscount window from the Group of Ten Central Banks, jointly or severally, should the build-up of earnings after twenty years be insufficient to pay T-Bill rates to the Bank in the event of widespread defaults to the affiliate.

The implications of the foregoing are as follows:

- Reestablishes creditworthiness of Brazil for growth — tied to an IBRD adjustment package and tranched.
- No principal is at risk at the Bank on new lending since it holds an IBRD guarantee through the put option.
- No risk to the IBRD bondholders since Brazil is on the books of the affiliate. The affiliate's strength is derived from initial capital contribution of IBRD, low cost funding and support if needed, from central banks — a contingent intervention, only after twenty years.
- IBRD will require a capital increase to permit it to continue to make quality high priority loans conditioned on economic performance and to support the put.
- There is an *opportunity* loss to the Bank after twenty years *if* the Bank chooses to exercise the put and receive the T-Bill rate — in effect a "penalty" rate, but one which has quite different accounting consequences as compared to a write-down. In effect, the Bank's "loss" is (a) delayed for twenty years; (b) spread out over the succeeding twenty years; and (c) is in the form of an opportunity loss.
- Industrialized countries or selected Central Banks — Japan comes to mind as a responsible "backstop" —

might agree to fund the affiliate after twenty years — through a lender of last resort or rediscount facility, if required — to permit the affiliate to pay T-Bill rates to their national commercial banks in the event (a) the LDCs do not service their interest obligations to the affiliate; and (b) the build-up over twenty years of the commitment fees for the put and the investment for twenty years of the initial capital contribution at a compounded rate of return is insufficient to permit the affiliate to meet its debt service obligations at the T-Bill rate to commercial banks. That event, however, would only occur in the event of a sustained default by many borrowers to the affiliate.

- Thus, the risk to fund the affiliate "in extremis" is conditioned and delayed and would rest with highly industrialized countries whose domestic financial institutions are the most at risk. It would only be needed under conditions of widespread defaults of LDCs to the affiliate beyond the accumulated twenty-year generation of earnings from capital and fees required to meet its obligations in years twenty-to-forty to the Bank.

- In effect the stockholders and bondholders of the IBRD are losing for twenty years the reserve build-up which otherwise would have been available if the initial investment was maintained at the IBRD. The stockholders of IBRD, however, do not look to the Bank for dividends. Its bondholders look to the callable capital and a quality ongoing financial and development institution to attract their support.

The framework I have described today is not *the* solution. There are variations and subtleties that could enhance effectiveness without damaging its underlying premise: *A realistic awareness of, and sharing of, risk in different ways according to the requirements and needs of the various constituencies, with a view to attracting sufficient funds to LDCs to facilitate economic growth and political stability.*

Testimony of Rodrigo Botero

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and

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Inter-American Dialogue

before the

Subcommittee on International Finance and Monetary Policy

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate

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I very much appreciate the sub-committee's invitation to testify on Latin America's debt problems. I want to clarify that I am testifying personally, not on behalf of any organization with which I am associated. I should add, however, that my assessment of Latin America's economic difficulties parallels the analysis and conclusions set forth in the recently-published report of the Inter-American Dialogue, of which I am Co-Vice Chairman. I strongly recommend that report for your consideration.

Background

The heavily indebted countries of Latin America and the Caribbean are in their sixth year of an economic crisis that has caused unprecedented hardship for the region. Because of its long duration, the magnitude of lost output, and the high social costs involved, this crisis has been more severe and painful than the Great Depression of the 1930s. The event that triggered the present crisis was the Mexican financial collapse of August 1982 and the subsequent suspension of voluntary lending to all of Latin America on the part of the commercial banks.

The region's economic problems are closely linked to the rapid build-up of foreign debt that took place during the past decade, to the terms under which the commercial debt was contracted, and to the uses to which the external resources were assigned. Excessive borrowing during the 1970s postponed required adjustments to external shocks, allowed the continuation

Senator SARBANES. Thank you very much, Mr. Botero, for a helpful statement.

Mr. Botero, let me ask you right off, on page 3—and I would be interested in having you elaborate on this—you say:

> A remarkable aspect of the debt crisis so far is the commitment of democratic governments in the region to remain within the existing international framework and to fulfill external obligations at a high political cost. This commitment should not be taken for granted.

I in a sense have been struck by that fact. How do you explain it?

Mr. BOTERO. Mr. Chairman, that is a very pertinent question. I believe that the untold political story in the hemisphere of this decade is the realization by Latin American elites, by political leaders, by the responsible leaders of the hemisphere, where Latin America truly belongs in the world.

The clear implication of this behavior is that they belong fundamentally in that group of Nations with whom they share the Judeo-Christian tradition, the Western world.

Many things account for that, but I believe of great importance, the events of Spain and Portugal have played that role, the realization that once democracy returned to Spain and Portugal, what did those two countries do? They had a choice: They had a choice of becoming leaders of the Third World. They opted to become full-fledged members of the European Economic Community and to join, in effect, the ranks of the industrialized West.

My impression is that the present leadership of Latin America is committed to that and are moving their countries in that direction.

Take just the three largest debtors, with over two-thirds of the debt: Argentina, Brazil, and Mexico. It is remarkable that the civilian leadership of those countries have, against enormous internal opposition, taken a position on the debt, taken a position since the debt crisis that what their countries must do is reform their economic management and continue to participate in the international financial community.

The calls from Cuban President Fidel Castro to, in fact, form a joint Latin American front and repudiate the debt have fallen on deaf ears. And even the actions of the Peruvian President Garcia to say, "Well, unilaterally let us slash the payment of debts to whatever percentage we consider appropriate," have not received support, have not found an audience in Latin America.

But as I say that, Mr. Chairman, I must also point out that political realities in the hemisphere are such that one cannot guarantee that this kinds of leadership will be in place indefinitely, particularly if all that these leaders have to offer their people is blood, sweat, and tears in order to continue to service the debt, to send resources abroad. This is simply, in my opinion, this is not sustainable for too long.

I think Mr. Robinson made earlier a reference to the result of the Mexican election where an opposition leader that proposed a moratorium on debt, received an impressive popular support, will in some way limit the options of President Salinas for the future.

If we look ahead, to what is happening in Brazil and in Argentina, where presidential elections are due in 1989, the risk that if each country must go to the electorate under the circumstances of

simply asking for indefinite tightening of the belt to continue on sending resources abroad, what we may be looking for in the not-too-distance future is different kinds of partners, different kinds of governments. And I cannot predict what that will be.

What I do see is a systematic weakening of what one could call the moderate, modernizing, western-oriented forces in the hemisphere unless they have some kind of breathing space, some kind of room to maneuver.

Senator SARBANES. Actually, it behooves us to move now because we have partners with whom we can work in a positive and constructive manner. There is no guarantee how long that situation will last.

In fact, the buildup of pressure and the failure to respond to it makes it increasingly likely that we will have a different set of partners that are not as willing to take this on.

Isn't that the high risk?

Mr. BOTERO. Absolutely, Mr. Chairman. I fully agree with what you said. That is precisely the way I see it.

Senator SARBANES. Let me put this question to both of you.

Mr. Rotberg, we have the fully developed statement, "Toward a Solution to the Debt Crisis." We earlier heard from Mr. Robinson, and he had extended appendices sketching something out. We have dealt with different proposals here in the hearings. You have heard us talk about general principles, and I am sure he could also lay out such an idea.

But, Mr. Rotberg, you said in your statement:

> The problem is not made easier by the fact that no entity has been given a mandate to allocate the pain and risk so as to avoid far worse outcomes down the road.

The question I put to you is: Where should the mandate be? I am not talking now about the substance of the proposal, because there is a range of those that need to be carefully explored. But we have had a difficult time here getting included in the trade bill and holding in the trade bill a very simple proposal to launch a study under the appropriate auspices and to move our Treasury to do that and to try to draw the international community into that.

Where should it be placed? What is it? While everyone talks about how important this problem is, just how serious it is and of overwhelming significance, yet what is missing in terms of moving us to really begin to come to grips with it.

MANDATE SHOULD REST WITH THE WORLD BANK

Mr. ROTBERG. I think that the short answer is that the mandate should rest with the World Bank, for several reasons:

First, they have demonstrated for over 40 years that they are objective, they are professional, they are nonpolitical in the best sense. They have a tremendous amount of expertise. They have the highest values. They have the judgment. And most important, they know what will work in a developing country, what can be pushed and what can't.

They need the mandate to act. To some extent that is inhibited by some very honest and serious concerns of the U.S. Treasury.

And it is not as if the Treasury takes a position which are untenable or unrealistic. They are quite concerned with how that man-

date could affect overall public policy. They are concerned about "moral hazard" and signals might be sent to banks, "It's OK to take losses or, to LDC's, "Look, you borrowed this money, but you don't have to pay back 100 cents on the dollar."

As I indicated in my statement, where do you draw the lines? There is a need for the World Bank, representatives of this legislature and the U.S. Treasury to sit down and work out the policy implications of specific proposals.

Senator SARBANES. Mr. Botero, do you have any views on that particular question as to where the mandate ought to be?

Mr. BOTERO. Mr. Chairman, I would tend to agree with Mr. Rotberg that of the multilateral organizations, the World Bank probably is the best, most ideally located. The fund, because it concentrates on balance of payments, tends to have a mandate that is relatively short-term-oriented. Here we are facing in a sense a development problem, and we need a longer period of time, a longer perspective, and the World Bank has it.

I would just add a point, that at least in the hemisphere it would be useful to have the IDB in some way involved because of the legitimacy it would give throughout the region, and that should not be impossible, just as on a worldwide basis, if the case of the Philippines were to be addressed, I think the Asian Development Bank or the African Development Bank in the case of Nigeria.

So, I would see the World Bank playing a major role and perhaps on the regional questions bring in the Inter-American Development Bank.

Senator SARBANES. What about a separate facility that would offer the opportunity to deal with its funding in a new way, unrelated to the traditions of either the bank or the IMF formulas and tying it more directly to the large surplus account countries?

Mr. ROTBERG. There is nothing structurally inappropriate about having a separate facility. But let's step back for a moment. The World Bank is not a magic institution. It is made up of governments. Governments own all the stock of the bank. There is no private stock held by the bank.

Second, the World Bank as an Aaa borrower can borrow as much money as it needs to fund its current operations or any future operations that you would think would be reasonable and necessary.

Three, there is nothing in the World Bank charter, in the Bretton Woods agreements, in its articles, which prevent it from doing anything that a new institution could do. It has total power to give guarantees and credit enhancement.

On might ask, then, why a separate facility? The argument is often made that a separate facility is needed because it will be a new beginning, but if governments are unwilling to let the bank, given its current plenary powers, do what is appropriate and is necessary, then those same governments are unlikely to permit the new institution that flexibility.

It's not as if the bank doesn't have the power. There is a current debate as to what the bank should be allowed to do. That debate, that honest difference of opinion, won't go away by the creation of a piece of paper, a document which creates a new institution.

The bank today can buy back debt. The bank today can subsidize. The bank today can do a whole range of things which would ad-

dress the debt crisis. If there is no national consensus on what should be done, I suspect it is unlikely that the creation of a new institution would finesse the current debate as to what should be done.

Having said all that, it is quite true that when you set up a new institution, there is a flush of excitement and that sometimes creates in itself a consensus and permits one to reconcile differences. Indeed, I started off by saying there's nothing wrong with it. I simply make the point that I suspect it isn't necessary.

I think Jim Robinson's proposal is a superb one. I think it is extremely valuable. I think it would work as a separate institution, as a subsidiary of the World Bank, as an affiliate of the World Bank, as a joint operation with the World Bank, or as a totally separate institution.

My point however, is to get the momentum moving to address the substantive issues of what should be done. The legal mechanistic framework of the formation of a new institution is, I would think, of lesser importance. And even in my own proposal I create an "affiliate" for technical reasons because I wanted part of the risk to be borne by an affiliate—other than the Bank itself for the callable capital behind it.

Senator SARBANES. Senator Graham?

Senator GRAHAM. Mr. Chairman, I want to commend you and the two superb presentations that we have just heard. I have been interested in this subject for many years, and I have learned as much in the last 2 hours as I have in a substantial period of time thinking about this question.

I am going to have to leave to preside at 4:30, so I would like to ask just two questions.

One, what should we be spending our time on in the next 6 months? And I ask that question out of the sense of pragmatic assessment that it is unlikely that the current administration in its remaining 180 or so days in office is likely to be suddenly energized to take on new initiatives on this subject.

But I believe that whoever assumes the Presidency on January 20 will be forced to face the implications of this issue. How could we use our time between now and January 20 in order that the new administration would be in the most advantageous position to begin to provide the leadership that both of you indicate that the United States must provide?

WHAT SHOULD BE DONE IN THE NEXT 6 MONTHS?

Mr. BOTERO. Senator, I would make two suggestions:

One, the Senate has already looked at—it is preparing within the framework of the trade legislation authorization to the executive to in fact move should the occasion arise. So, I would strongly encourage to the degree possible within the next 6 months, in cases where Acts of Congress are required, that those issues be addressed.

There is another one on which progress could be made between now and the end of the year. That has to do with strengthening the international financial institutions. There is legislation pending in the case of the CBI for a general increase of the World Bank. There is also a similar situation with respect to the IDB.

I would like to add a footnote to Mr. Rotberg's observation on the World Bank, and it is the following:

If we are going to tap the surplus countries—and for the moment let us say Japan and the Federal Republic of Germany—there is one issue that will have to be addressed, and I think some useful time could be spent in looking at that.

The capital structure of the World Bank gives Japan and the Federal Republic an extremely modest role in the capital of the bank. And today Japan and the Federal Republic have tremendously powerful economies, and that is not reflected in the voting power of the bank.

So, if a facility is structured within the bank—and I fully agree with Mr. Rotberg that it can be done—but in which Japan and the Federal Republic are going to be asked to contribute substantial resources—and that is as it should be because they do have the surpluses—some kind of global understanding, some kind of greater package could be negotiated between the United States, Japan, and the Federal Republic in which part of what they do, taking a greater share of responsibility in the international economy, is that they take on a greater-than-proportional role in this facility than what their present participation in the capital structure of the bank would give them.

That would be the only modification—which is really a footnote—that I would have to Mr. Rotberg's proposal. If we are going to bring in Japan and the Federal Republic into the scheme within the World Bank, sooner or later we will have to look into the question of their share of the capital of the institution.

Mr. ROTBERG. You have asked, Senator Graham, in essence a very personal question, "What might you do," or "What might this committee or this Senate do?" So, if you will forgive me, I would like to give you a rather personal response.

I can only ask myself what would I do. We have got all these constituencies around and we've got to keep things moving.

I would take the issue out of a formal sense—that is, out of a hearing—and I would insist, ask—"insist"—that perhaps six groups, no more than 10 people, sit together with you and your staffs: representatives fo the U.S. Treasury; second, a representative of the multilateral banks—that is, the World Bank and the IDB; third, three commercial banks; fourth, a representative of the Fed; fifth, a representative of the Comptroller of the Currency; sixth, two representatives of LDC's, perhaps Mexico and Brazil or Argentina and Brazil.

No more than 10 to 12 people. I would put them in a room for a few days with a representative of this Senate or your staffs with a mandate to argue out and debate a specific proposal which addresses the concerns of the various constituencies.

These people do not now sit in the room together. Two of them do: the banks and the LDC's. The World Bank is usually disinvited. They rarely sit with legislatures. The LDC does not sit with the Fed. And the Comptroller of the Currency does not sit with the Senate.

If we put the constituencies together, argue it out, debate it out, and in 1 month ask for a specific response to a specific proposal I would suggest that the communication between them will, one way

of inward-looking, import-substitution development strategies, and temporarily covered the consequences of fiscal laxity and exchange rate mismanagement.

A heavy price has been paid by these mistakes. The region is faced with the need not only to cope with the debt crisis, but also to bring about structural reforms, to correct past distortions, and to adjust to the shocks of a rapidly changing world economy.

The decade of the eighties has been lost in terms of overall economic development. Per capita output at the end of 1988 in Latin America and the Caribbean will be at the same level it had reached in the late 1970s. The rate of inflation and of unemployment will be higher.

Interest payments on the foreign debt are now equivalent to four percent of the region's output. From 1982 through 1987, Latin American countries have sent abroad some $240 billion to service their debts -- approximately $120 billion more than they received in new credits. Imports have been reduced drastically and governments have had to curtail investments and social programs. Real wages have decreased. In some countries, the rate of investment is insufficient to maintain the existing capital stock.

The debt crisis has coincided with a period of democratic renewal in Latin America. Several of the largest debtor countries are having simultaneously to manage an economic crisis and a process of political democratization.

A remarkable aspect of the debt crisis so far is the commitment of democratic governments in the region to remain within the existing international framework, and to fulfill external obligations at a high political cost. This commitment should not be taken for granted. A sustainable strategy for dealing with the debt crisis will have to be formulated within the constraints of democratic policy-making in the Hemisphere.

Need for Concerted Action

One of the lessons provided by the experience of the past six years is the need for concerted action by all the participants in the debt crisis if lasting progress is to be achieved. The major actors -- the governments of creditor and debtor countries, the commercial banks, and the multilateral organizations -- all view the problem from different perspectives, respond to different constituencies, and are driven by different motivations. But a constructive solution to the problem must allocate costs and benefits among the relevant actors in an equitable manner. The common shortcoming of unilateral schemes is that they tend to assign all or most of the costs to others while they seek to reap most of the benefits.

A typical rescheduling negotiation requires the agreement of a large number of commercial banks from North America, Western Europe and Japan. Negotiating authority with the debtor government is delegated to a small committee of leading banks. This committee and the debtor government representatives try to reach agreement on specific sums, financial terms, and legal conditions. This agreement, in turn, must be submitted by the committee of banks for final approval to all of the banks participating in the rescheduling operation, which can involve more than 100 different institutions. Eighteen months can go by between the beginning of the negotiations and the formal signing of an agreement. During that period, the Minister of Finance and the Governor of the Central Bank of the country will have spent weeks travelling between Tokyo, Frankfurt, London, Toronto, New York and Washington. Not surprisingly, as the commercial banks become more reluctant to lend, and the negotiations become more protracted and complex, the participants in these exercises are arriving at the conclusion that there must be a better way to approach the problem.

Concerted action on the part of such a heterogenous group of participants will require strong leadership from the principal industrialized country governments. For present purposes, these can be described as the Group of Seven countries: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

If the international financial community is going to move from the present strategy of "muddling through" to a comprehensive treatment of the debt crisis, the United States particularly will have to provide the initiative. Given its role in the world economy, its voting power in the multilateral financial organizations, and the exposure of U.S. commercial banks in this Hemisphere, any policy innovation towards developing country debt will require vigorous and sustained political leadership on the part of the United States.

During the past six years, there have been several instances of constructive and decisive intervention by the Federal Reserve and the Treasury Department to avoid the breakdown of specific negotiations or provide bridge financing for troubled debtor governments. But these sporadic, crisis-management actions have come about as short-term responses to an emergency rather than as part of a systematic, long-term policy initiative.

Treasury Secretary James Baker's proposal of October 1985 to change the focus of the debt strategy from austerity to growth was a step in the right direction. However, the financial flows that were to be provided by the commercial banks on a voluntary basis, according to the Baker proposal, did not materialize. The heavily indebted developing countries will not be able to resume economic growth if the international financial community imposes upon them a scheme whereby they remain exporters of capital to

the industrialized countries.

The present strategy towards the debt problems of the semi-industrialized developing countries does not seem sustainable, as it affects Latin America. The commercial banks are trying to reduce their exposure in the region, and the multilateral financial organizations are now receiving more in amortizations and interest from existing loans than what they are providing in new disbursements. As economic and social conditions continue to deteriorate in the major debtor countries, the costs of complying with the existing rules of the game are escalating. From within the governments, but particularly from the opposition groups, pressure is mounting in favor of a more aggressive negotiating posture vis-a-vis the international financial community.

Elements of a New Strategy

A concerted solution to the debt crisis which allows for renewed growth and economic reform in the heavily-indebted developing countries, as well as the financial stability of the commercial banking system, would have to incorporate the following elements:

1. There should be a significant increase in the level of official flows of long-term financial resources from the World Bank, the Inter-American Development Bank, and the Export-Import Bank. In cases requiring balance of payments

support or a monitoring role, the International Monetary Fund should also be able to increase its level of financing.

2. The debt service burdens of some countries will have to be reduced. The magnitude of the reduction should be sufficient to allow for a rate of Gross National Product (GNP) growth on the order of five percent per year. This reduction should be contingent on the adoption of an economic reform program by the government of the participating country which would encourage private investment, foreign as well as domestic, raise overall productivity, and improve export performance. Negotiation of the appropriate reduction as well as monitoring of compliance with the commitments agreed upon would be entrusted to an international organization acceptable to creditors as well as debtors.

3. A mechanism is needed for providing partial compensation to the commercial banks for the effects of the debt-service reduction, and for keeping them involved in trade financing and other short-term operations with the developing countries. This would almost certainly imply some form of asset substitution arrangement, directly supported by the governments of the industrialized countries, or guaranteed by those governments though a newly-created facility. Alternatively, the asset substitution scheme could be

managed by existing multilateral financial organizations, backed by guarantees from the industrialized country governments. Participation by the commercial banks would have to be voluntary. However, a well-designed system of incentives and disincentives could bring about widespread participation.

The existing debt strategy does not incorporate these three elements. The multilateral financial organizations are playing a marginal role in the process of restoring sufficient long-term capital flows to the region. Meanwhile, the debtor countries, as well as the commercial banks, are finding greater inducements to behave in a non-cooperative manner.

The present framework of managing the debt crisis is fragile. It is vulnerable to shocks from policy changes in the major debtor countries.

More than forty years ago, one of this nation's most distinguished statesmen, Secretary of State George C. Marshall, spoke about a troubled region of the world as follows:

"The farmer has always produced foodstuffs to exchange with the city dweller for the other necessities of life. This division of labor is the basis of modern civilization. At the present time it is threatened with breakdown. The town

and city industries are not producing adequate goods to exchange with the food-producing farmer. Raw materials and fuel are in short supply. Machinery, as I have said, is lacking or worn out. The farmer or the peasant cannot find the goods for sale which he desires to purchase. ...we cannot ignore the factor of the time involved. Disintegrating forces are becoming evident. The patient is sinking while the doctors deliberate. So I believe that action cannot await compromise through exhaustion...."

George Marshall was referring to conditions in Europe in 1947. But his words seem quite appropriate to describe the situation of many countries of Latin America and the Caribbean today.

Rodrigo Botero is Visiting Scholar at the Center for International Affairs, Harvard University, and Co-Vice Chairman of the Inter-American Dialogue. He is a former Minister of Finance of Colombia.

or another help fashion a response which will facilitate making the objectives I set out earlier.

With respect to the proposal just made about the sharing of power with Japan and Germany, I think it might be well to remember that although the World Bank has borrowed almost $100 billion, the vast majority of the bank's outstanding debt comes from Switzerland—Swiss francs, Japanese yen, and German marks.

As a matter of fact, in the history of the entire World Bank, the Dutch guilder has almost supplied as much money to the World Bank as the United States bond market.

The truth is that the World Bank, in its development role, is not financed by the United States. It is financed by Western Europe, OPEC, and Japan. It is their savings which have been lent to LDC's. So, the bank has already moved for almost two decades to financing itself outside the United States.

VOTING POWER

As for voting power, few issues get decided at the bank by votes. The United States is now down to about 18 percent, and in any event it is an institution which works for the most part on consensus—I can think of only a half dozen issues in 20 years in the World Bank where there was a vote which split the bank in any meaningful way.

For the most part, the institution makes professional, objective decisions without regard to who owns the stock.

Senator GRAHAM. Mr. Chairman. I wish I could stay longer. There is an issue that I would like to pursue, and that is the distinction between how we treat old debt and new debt and which of those represents the most appropriate lever to secure internal economic reform.

But I am afraid these questions will just have to be vibrating for now.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much.

Senator GRAHAM. Mr. Chairman, I just had a good suggestion, that I might submit some of those further follow-up questions for these two gentlemen and to be responded to for the record.

Senator SARBANES. Certainly.

We would appreciate your responses very much.

Senator SARBANES. Let me just follow up very briefly.

The provisions that are in the trade bill on international debt which were strongly resisted by the Treasury, even though in the end they were significantly altered and amended to try to meet a lot of the Treasury's objections, call on the Secretary of the Treasury to study the feasibility and advisability of establishing an international debt management authority and provide that we should initiate discussions to do that. But before he has to initiate discussions, he is under tremendous pressure.

We have a provision that if he determines the initiation of international discussions would: (A) result in material increase in the discount on which sovereign debt is sold; (B) materially increase the possibility of default on such debt; or, (C) materially enhance the likelihood of debt service failure, of disruption—if he makes

those determinations, then the Secretary tells the Congress and that is enough to initiate discussions, and we have a real tug of war about this.

It goes to your point that there is an unwillingness to explore this area because of a fear or apprehension that if you want to even begin the exploration of it, lots of dire developments will take place, we will start down the slippery slope, I guess, and you won't be able to stop or draw a line.

So, to avoid doing that, to avoid that happening, you do nothing or you sort of muddle through, as we have been doing.

How realistic is that, I guess is the first question.

And even if realistic and therefore there is some risk, isn't the risk of not exploring even greater?

You can address those two questions.

Mr. ROTBERG. I guess whenever we see terms like "slippery slope" and "dominoes," we should perhaps ask ourselves what the real problem is.

In my view, there is little chance that a report, a study, an evaluation, would prompt any dire consequence. The banks know what the issues are. The LDC's know what the issues are. And the fact that the U.S. Congress, the House, and the Senate, will get a report in several months or 6 months—which I assure you will not be meaningful after all the caveats are added—could prompt any untoward event is simply not correct.

Second, there is a sense that a lot has already been done, and it is, frankly, a little late in an administration to gear up a major new study. They have been working on this matter for years, and frankly, they would argue, with no disrespect, that attention should have been paid to this issue in 1980, in 1982, and in 1984. And to do something in the last 3 or 4 months of an administration is unnecessary.

Would a report do any harm? No. If nothing is asked for, however, given all the publicity attendant to it, a great deal of damage could be done because then you are giving a signal to Latin America that this Congress does not feel it is necessary to review the matter.

In short, the very asking for it and insisting on it is an appropriate policy by the U.S. Congress because it shows interest rather than disinterest.

Second, if the Latin American constituency perceives that even a status report is blocked by Treasury, then you could escalate and aggravate what is a very fragile political situation in Latin America.

In short, a study could do good. I don't understand why they don't want it given how its been so watered down. It could do harm at this juncture however, if dropped, because it has been escalated to an issue now which has been blown up out of all proportion.

Senator SARBANES. Mr. Botero, do you want to add anything to that?

Mr. BOTERO. No, Mr. Chairman.

Senator SARBANES. Let me just observe, in an excess of sensitivity to the Treasury, we wrote what is in the trade bill in a way that the report did not come from this Treasurer. So, we are setting up the process for the next Treasurer. Even so, this item was cited as

a basis for a Presidential veto. Now we expect it to pass as part of a trade bill.

Gentlemen, thank you very much.

I noticed that Mr. Robinson has stayed throughout, and we want to thank him for that. I guess we also ought to thank the American Express Co., for lending him to us for the afternoon.

Mr. Robinson, it is a measure of your own deep and genuine interest in this subject that you sat through this panel and the questions put to them, and in light of that I feel I ought to invite you if you have any comments you might want to make on what you have just heard from this panel, since you were before the committee to testify on that. It is not often we get a witness who comes in, gives his testimony, and then doesn't stride from the room. I think we ought to give you another chance to comment on what the other two gentlemen have had to say.

Mr. ROBINSON. Mr. Chairman, thank you for this unexpected opportunity.

I found myself in full agreement and cheering for what was said because we all are saying basically the same thing. We have got to have a way of getting the various stakeholders together.

I might add, in Mr. Rotberg's list of people which you pulled together, that I would be inclined to ask the U.S. Trade Representative to come in also because otherwise you get too much finance without enough trade.

But I think that the way that they have analyzed the issues and the problems, that I am in full agreement, and it represents a constructive contribution to the process. I think that the progress of that process is very full. As Gene says, that shows interest on the part of Congress and the policy leaders in this country, and that makes a major contribution.

Senator SARBANES. Let me simply say in closing that I think that Senator Graham was absolutely right when he spoke of how significant your contributions have been here today in consideration of these issues. It has just been outstanding testimony, and I know a great deal of time and effort went into preparing it.

We are most grateful to all three of you. Thank you very much.

The committee stands adjourned.

[Whereupon, at 4:35 p.m., the subcommittee was adjourned.]

NEW DIRECTIONS FOR DEALING WITH THE INTERNATIONAL DEBT PROBLEM

THURSDAY, AUGUST 4, 1988

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

Present: Senators Sarbanes, Proxmire, Dixon, Graham, Sanford, Heinz, and Bond.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The subcommittee will come to order.

This is the second of two hearings which the subcommittee on International Finance and Monetary Policy is holding this week on the issue of international debt.

On Tuesday, the subcommittee heard exceptionally effective testimony from James Robinson, the chairman of the American Express Co.; Eugene Rockford, the former Vice President and Treasturer of the World Bank and now a senior vice president at Merrill Lynch; and Rodrigo Botero, the former Finance Minister of Colombia and the cochair of the Inter-American Dialogue; about the financial trade and foreign policy consequences of the debt burden of the developing countries.

Each had a particular approach to suggest for addressing this problem, but I think it's fair to say that all three agreed on the urgency of the problem and the need to reexamine the current approach.

This morning we are very pleased to have with us two exceptionally knowledgeable panels, one from the banking community and one from the academic community, to discuss the international debt problem and possible approaches for addressing it.

In the second panel, which we will hear from later in the morning, we'll have Albert Fishlow, chairman of the Department of Economics at the University of California at Berkeley; Rudiger Dornbusch, professor of economics at MIT; Shafiqul Islam, senior fellow at the Council on Foreign Relations.

Each of them has done extensive academic work on the debt issue and is widely respected in their field.

In the panel that we will now be hearing from, our first panel, we're very pleased to have Rodney Wagner, vice chairman of credit

policy for Morgan Guaranty Trust Co., who was very much involved in helping to craft Morgan Guaranty's Mexican debt proposal; Peter Nicholson, senior vice president of the Bank of Nova Scotia, who has put forward a very carefully formulated debt proposal; and Peter Rona, president and CEO of IBJ-Schroder Bank and Trust Co., who's very knowledge about the approach of the Japanese and European commercial banks on the debt issue.

I want to report that the Congressional Research Service has forwarded to the Banking Committee a report which will be made available this morning on the exposure of U.S. banks from 1982 to 1987 in the 17 developing countries classified by the World Bank as highly indebted.

The principal findings of this CRS report is that while the total exposure of U.S. banks in these 17 highly indebted countries has fallen by just over 10 percent since the recognized onset of the international debt crisis in 1982, much of this decline is attributable to a decrease in the level of exposure of the nonmoney center banks. The report finds that the nine money center banks have also experienced an improvement in their position, vis-a-vis the 17 highly indebted developing countries, but concludes that they remain significantly exposed.

The report also finds that there's been a significant shift in the composition of U.S. bank exposure between the public and private sectors in the 17 debtor countries. Between 1982 and 1987, the relative shares of debt owed by the public and private sectors in the borrowing countries have reversed. In 1982, close to two-thirds of all debt owed was owed by the private sector. By 1987, somewhat over two-thirds of the total debt was owed by the public sector.

I think it's fair to say that the report indicates that despite some improvement, at least in a financial sense, the international debt issue remains a matter of significant concern for the U.S. financial system as well as obviously for U.S. trade and foreign policy interests.

[The complete prepared statement of Senator Sarbanes follows:]

OPENING STATEMENT

SENATOR PAUL S. SARBANES

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

August 4, 1988

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This morning we are fortunate to have with us two exceptionally knowledgeable panels from the banking and academic communities to discuss the international debt problem and possible approaches for addressing it. On the second panel later this morning we will have Albert Fishlow, Chairman of the Department of Economics at the University of California at Berkeley; Rudiger Dornbusch, Professor of Economics at MIT; and Shafiqul Islam, Senior Fellow at the Council on Foreign Relations. Each of these

witnesses has done extensive academic work on the debt issue and is widely respected in the field. On the first panel we have Rodney Wagner, Vice Chairman of Credit Policy for the Morgan Guaranty Trust Company, who helped craft Morgan Guaranty's Mexican debt proposal; Peter Nicholson, Senior Vice President of the Bank of Nova Scotia, which has put forward a very carefully formulated debt proposal; and Peter Rona, President and CEO of IBJ-Schroder Bank and Trust Company, who is very knowledgeable about the approach of the Japanese and European commercial banks on the debt issue.

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The report also finds that there has been a significant shift in the composition of U.S. bank exposure between the public and private sectors in the seventeen debtor countries. Between 1982 and 1987 the relative shares of debt owed by the public and private sectors in the borrowing countries have reversed. In 1982 close to two-thirds of all debt owed by the seventeen

countries was owed by the private sector; by 1987, somewhat over over two-thirds of the total debt was owed by the public sector.

The report would seem to indicate that, despite recent improvements, the international debt issue remains a matter of significant concern for the U.S. financial system, as well as for U.S. trade and foreign policy interests.

With that, let us proceed with the first witness, Mr. Warner from the Morgan Guaranty and Trust Company.

After we hear from other members of the subcommittee, we will be prepared to go to the panel. Senator Bond.

Senator BOND. I pass. Thank you.

Senator SARBANES. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Mr. Chairman, I want to commend you enthusiastically for holding these hearings. I regret that I was unable to attend because we had a markup in the subcommittee of the Appropriations Committee which I chair. I understand it was brought out at that hearing that this administration has taken too narrow a perspective on the international debt problem. It's intended to look at it solely as a banking problem and it has not fully appreciated its impact on political developments in Latin America, including in some countries an increased reliance on the drug trade as the only certain cash crop for export.

Mr. Chairman, since any new administration may wish to take a new approach to this issue, I think these hearings and the provisions you sponsored in the trade bill will provide a sound basis for the exploration of new approaches.

I would just like to add one perspective. This is a very, very difficult time for our country and for our banks to engage in international loans. It's essential that we do it, no question about it, but we have to be also sensitive of the status of our country. We have never been in the kind of debt situation we are today. We all know we have a national debt of $2.5 trillion. Fewer people realize our households are even more deeply in debt, over $3 trillion; and our business is in debt to the extent of more than $4 trillion. We've never had any country in the history of mankind that's been as heavily in debt as we are.

Much of this is now focused on our financial institutions. We all know about the savings and loans, the great difficulty they're in, the huge losses that they're suffering at the present and the fact that they're going to require a big rescue. We know now that the Federal Deposit Insurance Corporation which insures our banks is going to suffer the only loss that it's suffered in the 50 years in which it's been in existence. So our banks are in great trouble.

This is complicated further by the fact that right now we are reaching for an 8 percent capital ratio internationally for our banks and for the banks throughout the world. This will especially hit our money center banks and also, of course, the Japanese banks, for instance, which Mr. Rona is an expert in. I understand they will be particularly affected by that. So this is going to be a very difficult time and, of course, we can't also escape from the fact that just last year some of our banks properly took—earlier this year I guess it was—properly took a terrific hit to adjust their reserves properly and recognize the reality of the fact that they're not going to be able to have their debtors make good on the debts they owe.

So this is an extraordinarily difficult time. It's hard for us to work out a policy which is prudent and recognizes the absolute necessity that we provide credit internationally to countries through-

out the world, but at a time when we're in great difficulty ourselves.

I know of nobody who's better qualified by his own intelligence and background and knowledge to chair this subcommittee and help our country deal with these matters than Paul Sarbanes. So at least that's in good hands.

Senator SARBANES. Thank you very much, Mr. Chairman.

Before we begin, I have statements from Senator Dixon and Sanford to be inserted in the record.

[The statements follow:]

AUGUST 4, 1988

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE HEARING
ON
THIRD WORLD DEBT ISSUES

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE INTERNATIONAL FINANCE SUBCOMMITTEE CONTINUES ITS HEARINGS ON INTERNATIONAL DEBT ISSUES. WE HAVE A DISTINGUISHED AND EXPERT GROUP OF WITNESSES BEFORE US THIS MORNING, AND I AM SURE THE SUBCOMMITTEE WILL FIND THEIR TESTIMONY TO BE INFORMATIVE AND HELPFUL.

AS I STATED AT THE OPENING DAY OF HEARINGS ON TUESDAY, I THINK THE SO-CALLED "THIRD WORLD DEBT CRISIS" IS WELL ON ITS WAY TO BEING SOLVED, IF ALL WE ARE CONCERNED ABOUT IS THE SAFETY AND SOUNDNESS OF THE U.S. BANKING SYSTEM. ACTIONS TAKEN BY THE BANKS AND THE FEDERAL BANKING REGULATORS OVER THE PAST SEVERAL YEARS

HAVE STEADILY DECREASED THE RISKS THIS PROBLEM HAS POSED FOR OUR BANKS.

HOWEVER, WE NEED TO BE CONCERNED ABOUT MUCH MORE THAN THE SAFETY OF OUR OWN BANKING SYSTEM, AS CRUCIAL AS THAT ISSUE IS. WE ALSO MUST BE CONCERNED ABOUT SUCH THINGS AS THE IMPACT OF THIS CRISIS ON THE DEBTOR COUNTRIES THEMSELVES, AND THE EFFECT IT HAS ON OUR INTERNATIONAL TRADE POSITION. WHEN YOU CONSIDER THESE FACTORS, THE OUTLOOK IS FAR LESS ROSY. I AM VERY PLEASED, THEREFORE, THAT THE CHAIRMAN HAS CALLED THESE HEARINGS. I CONGRATULATE HIM FOR HIS LEADERSHIP ON THIS ISSUE, AND FOR FOCUSING THE COMMITTEE'S ATTENTION ON THE FULL DIMENSIONS OF THIS CRISIS. I LOOK FORWARD TO WORKING WITH HIM AND ALL INTERESTED PARTIES IN AN EFFORT TO ENSURE THAT THE UNITED STATES PLAYS THE KIND OF KEY ROLE THAT IT SHOULD PLAY IN MANAGING THE DEBT SITUATION.

OPENING STATEMENT OF SENATOR TERRY SANFORD
HEARING ON THE INTERNATIONAL DEBT PROBLEM

AUGUST 4, 1988

MR. CHAIRMAN, I COMMEND YOU FOR HOLDING THESE HEARINGS ON THE INTERNATIONAL DEBT PROBLEM. I THINK WE CAN ALL AGREE THAT CURRENT APPROACHES TO THE INTERNATIONAL DEBT PROBLEM ARE INADEQUATE. WE HAVE HEARD IN EARLIER TESTIMONY THAT IN CENTRAL AMERICA, AN ENTIRE DECADE OF ECONOMIC DEVELOPMENT HAS BEEN LOST. THE GOAL OF THESE HEARINGS SHOULD BE TO BETTER OUR UNDERSTANDING OF THE FAILURE OF OUR CURRENT APPROACH, AND TO IDENTIFY NEW POLICIES AND PROGRAMS TO ADDRESS THESE FAILURES.

WHAT I BELIEVE WILL COME TO LIGHT IN THESE HEARINGS IS THAT THE ENORMOUS DEBT OF THE LESSER DEVELOPED COUNTRIES, IN PARTICULAR THE CENTRAL AMERICAN COUNTRIES, HAS HAD A DIRECT AND NEGATIVE EFFECT ON OUR OWN ECONOMY, AND THAT EFFECTIVE MEASURES TO RESOLVE THIS CRISIS ARE IN OUR OWN BEST INTEREST AS WELL AS IN THE INTEREST OF EVERY HEAVILY-INDEBTED NATION. WHEN THESE NATIONS FALL SO FAR INTO DEBT, WE LOSE A VALUABLE TRADING PARTNER, AND FACE THE DESTABILIZATION OF THE ECONOMIC ORDER TO WHICH WE ALL BELONG.

WE MUST LOOK AT EVERY REASONABLE POSSIBILITY, AND NOT REJECT OUT OF HAND ANY APPROACH WHICH WILL BEGIN TO IMPROVE THE ECONOMIC PICTURE. THE PAST FEW YEARS HAVE BEEN FILLED WITH A LASSITUDE ON THE PART OF THE UNITED STATES IN DEALING WITH THIS MOUNTING CRISIS. WE HAVE BEEN PASSIVE, AND WE HAVE REACTED TO SPECIFIC DIFFICULTIES AS THEY OCCURRED. WE MUST NOW INITIATE ACTION, AND DEVELOP LONG-RANGE PLANS TO REPLACE THE HIT OR MISS APPROACH OF THE PAST. IT IS TIME WE BEGAN TO DISCUSS RESCHEDULING OF DEBTS AND THE POSSIBILITY OF DEBT FORGIVENESS, WHILE AT THE SAME TIME NOT PUNISHING THOSE NATIONS WHICH HAVE ATTEMPTED TO FULFILL THEIR OBLIGATIONS AT HIGH ECONOMIC AND POLITICAL COST. WE MUST ALSO REALIZE THAT THE UNITED STATES, A DEBTOR NATION ITSELF, IS NO LONGER CAPABLE OF SINGLE-HANDEDLY MANAGING THIS RECOVERY. OTHER ECONOMIC POWERS MUST BECOME PART OF THESE EFFORTS, AND SHOULDER PART OF THE BURDEN AS THEY ENJOY THE BENEFITS OF BEING A U.S. TRADING PARTNER.

BUT IT WOULD BE A MISTAKE, MR. CHAIRMAN, TO SIMPLY APPROACH THE FOREIGN DEBT CRISIS AS AN ECONOMIC ISSUE. IT IS A POLITICAL ISSUE, AS THESE FLEDGLING DEMOCRACIES TEETER ON THE BRINK OF COLLAPSE DUE TO UNREST AND DISSATISFACTION. IT IS A HEALTH ISSUE, AS THESE SAME COUNTRIES FIND THE ONLY SUBSTANTIAL INCOME IN EXPORTS FROM DRUG TRAFFICKING TO THE UNITED STATES. AND IT IS A MORAL ISSUE, AS WE RAMP THE

Senator SARBANES. Gentlemen, I think we'll start with Mr. Wagner and then move right across the panel. We'll hear all of your statements first and then question the panel altogether at the conclusion of those statements.

STATEMENT OF RODNEY B. WAGNER, VICE CHAIRMAN OF CREDIT POLICY, MORGAN GUARANTY TRUST CO., NY

Mr. WAGNER. Mr. Chairman and members of the subcommittee, I'm pleased to be here today to discuss debt exchanges, and in this regard, will focus my remarks on the Mexican exchange in which Morgan Guaranty acted as adviser to the Mexican Government. Of course, I will be pleased to try to respond to any questions you may have on the Mexican transaction or other matters pertaining to LDC debt problems.

As we are all so well aware, the lesser developed countries have a severe shortage of foreign exchange, which inhibits their growth, as well as the servicing of their foreign debt. Over the last 6 years, banks have rescheduled principal payments and reduced interest rate spreads—Brazil being the most recent example with bank negotiations just completed that will reschedule $64 billion of principal payments and reduce interest rate spreads to thirteen-sixteenths over LIBOR, as well as borrowing $5.2 billion of new money. Despite such efforts, the severe foreign exchange shortage continues in most LDC's.

RESOURCE GAP PROBLEM

There are two ways for creditors to approach the resource gap problem—either lend more money or find a way to reduce the debt outstanding and thereby lower the annual outflow of foreign exchange to pay interest. Debt exchanges are a way to achieve the latter objective. This is the objective of lowering the amount of debt outstanding and therefore reducing interest payments.

In order to be successful, any debt exchange must be voluntary with each bank having the choice to participate or not depending on its own judgment. If the debt exchange is forced rather than voluntary, then we believe relations between borrower and lender will be severely damaged, undermining the ultimate objective of restoring the country's access to the voluntary markets. Success of a debt exchange program depends on offering banks a new debt instrument that will attract them to accept it at a discount for their existing loans. If enough banks exchange their loans at a low enough discount, then the borrowing country will lower its future interest payments and the banks will have a better quality debt instrument.

We, of course, follow closely the countries where we have loans outstanding and have been impressed with the progress Mexico has made over the last several years. They have addressed such structural problems as opening up imports, which has stimulated competition within Mexico to the overall public benefit; exports are being encouraged, resulting in nonoil manufactured exports now being larger than oil exports; tourism is being promoted and is increasing, providing more jobs for Mexicans and needed foreign exchange; flight capital has begun to flow back to Mexico as confi-

dence has grown and the growth rate has turned upward. There are, of course, still some serious problems—inflation and job creation, to name two—but the Mexican authorities are hard at work on these.

Starting in 1986, we watched Mexico's foreign exchange reserves grow from about $5 billion to close to $15 billion. This was due to a combination of factors, including, higher oil prices, strong nonoil exports, and the financial package put together by the IMF, IBRD, and the banks.

When reserves reached a fairly high level, Mexico had three options for using such reserves. It could save them for a rainy day, such as a dramatic drop in oil prices; use them for stimulation of growth; or reduce some debt. If the reserves were high enough and used prudently, Mexico could do some of all three. As a bank, we believed we had a responsibility to work with Mexico on alternative ways of managing their debt to minimize the costs to the country while, at the same time, attracting the voluntary participation of bank lenders.

Last summer, in collaboration with Mexican officials, we devised a transaction designed to benefit Mexico by taking advantage of the market for Mexican credit. As a result, Mexico offered its creditor banks the opportunity to exchange some of their loans for new bonds. The principal of the new 20-year bonds is collateralized by 20-year zero coupon U.S. Government securities purchased by Mexico. These cost about 17 cents for a bond that is equal to $1 at maturity in 20 years. These securities are held by the New York Federal Reserve and in 20 years any holder of the bonds is certain to receive full payment of principal.

The interest on the bonds is 1⅝ percent over LIBOR, double the margin of thirteen-sixteenths percent over LIBOR that the banks receive on their bank loans. In order for a bank to receive these new bonds, it had to bid for them, with payment to be made by exchanging some of the bank's loans for the bonds.

MEXICAN BONDS

These new Mexican bonds have certain features of interest to the banks:

(1) The principal of the bonds is fully collateralized;

(2) The bonds carry a higher interest rate than existing bank loans;

(3) The bonds are to be more marketable than bank loans;

(4) They will not be included in rescheduling of bank loans; and

(5) Holders of the bonds will not be asked by Mexico to participate in any future new money programs.

To implement this transaction required extensive work on legal, accounting, and regulatory matters and it was facilitated by the agreement of the U.S. Treasury to make available the zero coupon securities for Mexico to purchase.

The results were announced in March. Mexico received bids of $6.7 billion from 139 banks in 18 countries. Of these bids, Mexico accepted approximately $3.7 billion at an average bid price of 69.77 cents per dollar of loans tendered. This is an average discount of just over 30 percent. The highest bid accepted was 74.99 cents of

bonds for each dollar of loans. This has reduced Mexico's total outstanding debt by $1.1 billion and will save Mexico about $1.5 billion in interest payments over the life of the bond issue. Mexico used about $500 million of its reserves to purchase the zero coupon U.S. Government bonds to collateralize the new bonds.

While the size of the transaction was not as large as we would have liked, the transaction has been a success not only for Mexico, but also in that it introduced a new voluntary, market-oriented technique that can be used in addressing the debt problem of developing countries.

Now to induce more banks to bid, we believe future debt exchanges will require added enhancements of the new debt. The most obvious enhancement would be some sort of guarantee of interest. A full guarantee of all interest would be prohibitively expressive and we believe is not needed. Rather, a rolling guarantee, say of several years' interest. Each year interest is paid, the guarantee rolls forward another year. If the country fails to pay interest, then the guarantee is called upon and a lender is certain of receiving interest. The country then has time to resume payment of interest by taking necessary action to correct its problems.

Such enhancement of these forms of debt exchanges raises a major question—Who will provide the guarantees to make such a program work? The LDC's do not have sufficient resources to purchase collateral for their principal and cover interest costs. Some assistance is needed to make this work.

Also, some sort of sensible criteria have to be developed as to which countries qualify for the guarantees. This should certainly be related to performance, and perhaps require that the LDC provide part of the funds for such a program. If such criteria are not developed, the guarantor could be overwhelmed by applicants.

We have never looked upon the debt exchange technique as a panacea for the LDC debt problem. We do believe that as banks become more familiar and comfortable with it, and as the technique is improved and modified, it will become a more useful option for managing debt.

Thank you, Mr. Chairman.

[The complete prepared statement of Mr. Wagner follows:]

Senator SARBANES. Thank you very much, Mr. Wagner.
Mr. Nicholson.

STATEMENT OF PETER J. NICHOLSON, SENIOR VICE PRESIDENT, BANK OF NOVA SCOTIA

Mr. NICHOLSON. Thank you very much, Mr. Chairman. It's particularly a privilege for me and indeed an honor to be able to come here before this subcommittee and present the views of the Bank of Nova Scotia as to what in our view would be a constructive new approach to the chronic problem of LDC debt.

Since we may not be entirely familiar to you as an organization, perhaps I could begin with a few words about our bank.

We are the fourth largest bank in Canada with assets of roughly $58 billion, which makes us approximately the size of Bankers Trust. Roughly half of our business is generated outside of Canada. In particular, we've had a long and successful history in the United States dating from the establishment of our first office in Minneapolis in 1885, even before we had set up in Toronto. Today we are represented in eight cities in this country and have earning assets here of over $9 billion.

As to our exposure to LDC debt, we have a gross exposure of $3.5 billion, which is roughly 20 percent of all Canadian bank exposure. We have reserves against this of about 40 percent.

So with this as background, I will turn now to our thoughts on the debt strategy. We have always shared the consensus clearly articulated by Secretary Baker in 1985 that the LDC debt problems could not be resolved without a resumption of strong growth in the debtor countries, roughly 5 to 6 percent a year on average.

The central flaw in the official debt strategy in our view is that it has proven incapable of stimulating the financial resource flows needed to regenerate adequate levels of growth, and in that sense the strategy has been inconsistent with its most fundamental premise. We are convinced that it is very unlikely that this situation will change unless some fundamentally new elements are added to the strategy.

Because of the sheer scale of the debt problem, it has economic and political significance which makes it much more than a banking problem, which you've already noted. But at least in its banking aspects we view it as a big workout, no different in principle than the workouts we have often faced with domestic commerical borrowers in circumstances where foreclosure is not a practical option. In those cases, a lender sits down with the customer and negotiates a set of conditions calculated to restore financial health. Typically these involve a period of reduced debt service, often including lower interest rates geared to the borrower's ability to pay. Performance conditions will also typically be attached.

So, Mr. Chairman, taking our cue from this conventional workout model, our proposal was designed with two primary objectives in mind. First, to provide cash flow relief to debtors in amounts sufficient to help reignite growth but within the capacity and willingness of commercial banks to provide; and second, to remove some of the uncertainty associated with the value of LDC debt and thus increase confidence in the international banking system, the

importance of which has recently been stressed by Senator Proxmire. Now, in outline, our approach has six principal elements.

RECOMMENDATIONS FOR REDUCING LDC DEBT

(1) Creditors would negotiate reduced rates of interest with a particular debtor country. The negotiated rate would be geared to some concept of "ability to pay". It might be subject to periodic adjustment back toward a market rate as the country's creditworthiness recovered.

(2) The principal amount of the debt would be kept intact though no repayments might be scheduled for several years. Relief for the debtor country would be in the form of reduced interest payments. This is where the cash flow bind is occurring now since principal repayment has already been postponed for many years in virtually all cases.

(3) Loan principal would be guaranteed by the pledge of a zero-coupon U.S. Government bond as collateral, just as Mr. Wagner has mentioned. This bond might be purchased using foreign currency reserves of the debtor country, as Mexico has done; or if reserves were insufficient, with the help of special lending by international financial institutions and possibly the creditor banks.

(4) Interest Insurance. Any reduced interest payments negotiated in the first step would be insured. The insurance would be provided by a pool of funds contributed, upfront, by the lending banks themselves in proportion to their exposure to the country in question. To give this self-insurance feature complete credibility—and this I stress is a crucial feature—the bank-funded pool would be ultimately backed by industrial country governments. This guarantee would probably be made through auspices of the World Bank/IMF group.

(5) New Money. There will still be a requirement for new lending. Commercial banks would be expected to maintain short-term lines of credit for purposes such as trade finance and bridging of project loans. It is clear that medium and longer term lending to countries for balance-of-payments purposes is not an appropriate activity for commercial banks. Therefore, until a country regains its ability to tap the private bond and equity markets, it must rely on loans from official sources in the medium- and long-term range, including export credit agencies, the development banks and the IMF.

Mr. Chairman, the sixth and final feature of our proposal contemplates an international facility. Implementation of our plan would almost certainly require the creation of a facility of some sort within the World Bank/IMF group. I stress that this facility would not own debt. Its purpose would be to administer the back-up guarantee of the insurance pool and provide objective expertise in helping to negotiate reasonable interest rate reductions. It would represent the interest of creditor governments which are guarantors of the interest insurance feature.

Now, Mr. Chairman, a number of specific advantages of this approach merit emphasis and I might run through those quickly.

Statement of Rodney B. Wagner

Vice Chairman of the
Credit Policy Committee
of
Morgan Guaranty Trust Company
of New York

before the

Subcommittee on International Finance
and Monetary Policy

of the

U.S. Senate Committee on
Banking, Housing and Urban Affairs

August 4, 1988

Chairmen and members of the subcommittees, my name is Rodney B. Wagner. I am Vice Chairman of the Credit Policy Committee of Morgan Guaranty Trust Company of New York. I am pleased to be here today to discuss debt exchanges, and in this regard, will focus my remarks on the Mexican exchange in which Morgan Guaranty acted as advisor to the Mexican government. Of course, I will be pleased to try to respond to any question you may have on the Mexican transaction or other matters pertaining to LDC debt problems.

As we are all so well aware, the lesser developed countries have a severe shortage of foreign exchange, which inhibits their growth, as well as the servicing of their foreign debt. Over the last six years, banks have rescheduled principal payments and reduced interest rate spreads - Brazil being the most recent example with bank negotiations just completed that will reschedule $64 billion of principal payments and reduce interest rate spreads to 13/16th over LIBOR, as well as borrowing $5.2 billion of new money. Despite such efforts, the severe foreign exchange shortage continues in most LDC's.

There are two ways for creditors to approach the resource gap problem - either lend more money or find a way to reduce the debt outstanding and thereby lower the annual outflow of foreign exchange to pay interest. Debt exchanges are a way to achieve the latter objective.

In order to be successful any debt exchange must be voluntary with each bank having the choice to participate or not depending on its own judgment. If the debt exchange is forced rather than voluntary, then we believe relations between borrower and lender will be severely damaged, undermining the ultimate objective of restoring the country's access to the voluntary markets. Success of a debt exchange program depends on offering banks a new debt instrument that will attract them to accept it at a discount for their existing loans. If enough banks exchange their loans at a low enough discount, then the borrowing country will lower its future interest payments and the banks will have a better quality debt instrument.

We, of course, follow closely the countries where we have loans outstanding and have been impressed with the progress Mexico has made over the last several years. They have addressed such structural problems as opening up imports, which has stimulated competition within Mexico to the overall public benefit; exports are being encouraged, resulting in non-oil manufactured exports now being larger than oil exports; tourism is being promoted and is increasing, providing more jobs for Mexicans and needed foreign exchange; flight capital has begun to flow back to Mexico as confidence has grown; and the growth rate has turned upward. There are, of course, still some serious problems - inflation and job creation, to name two - but the Mexican authorities are hard at work on these.

Starting in 1986, we watched Mexico's foreign exchange reserves grow from about $5 billion to close to $15 billion. This was due to a combination of factors; for example, higher oil prices, strong non-oil exports, and the financial package put together by the IMF, IBRD, and the banks.

When reserves reached a fairly high level, Mexico had three options for using such reserves: it could save them for a rainy day, such as a dramatic drop in oil prices; use them for stimulation of growth; or reduce some debt. If the reserves were high enough and used prudently, Mexico could do some of all three. As a bank, we believed we had a responsibility to work with Mexico on alternative ways of managing their debt to minimize the costs to the country while, at the same time, attracting the voluntary participation of bank lenders.

Last summer, in collaboration with Mexican officials, we devised a transaction designed to benefit Mexico by taking advantage of the market for Mexican credit. As a result, Mexico offered its creditor banks the opportunity to exchange some of their loans for new bonds. The principal of the new 20-year bonds is collateralized by 20-year zero coupon United States Government securities purchased by Mexico. These cost about 17 cents for a bond that is equal to $1.00 at maturity in 20 years. These securities are held by the New York Federal Reserve so that in 20 years any holder of the bonds is certain to receive full payment of principal.

The interest on the new bonds is I 5/8% over LIBOR, double the margin of 13/16% over LIBOR that the banks receive on their bank loans. In order for a bank to receive these new bonds, it had to bid for them, with payment to be made by exchanging some of the bank's loans for the bonds.

These new Mexican bonds have certain features of interest to the banks:

1) The principal of the bonds is fully collateralized.
2) The bonds carry a higher interest rate than existing bank loans.
3) The bonds are to be more marketable that bank loans.
4) They will not be included in rescheduling of bank loans.
5) Holders of the bonds will not be asked by Mexico to participate in future new money programs.

To implement this transaction required extensive work on legal, accounting, and regulatory matters and was facilitated by the agreement of the United States Treasury to make available the zero coupon securities.

The results were announced in March. Mexico received bids of $6.7 billion from 139 banks in 18 countries. Of these bids, Mexico accepted approximately $3.7 billion at an average bid price of 69.77 cents per dollar of loans tendered. This is an average discount of just over 30%. The highest bid accepted was 74.99 cents of bonds for each dollar of loans. This has

reduced Mexico's total outstanding debt by $1.1 billion and will save Mexico about $1.5 billion in interest payments over the life of the bond issue. Mexico used about $500 million of its reserves to purchase the zero coupon U.S. government bonds to collateralizing the new bonds.

While the size of the transaction was not as large as we would have liked, the transaction has been a success not only for Mexico, but also in that it introduced a new voluntary, market-oriented technique that can be used in addressing the debt problem of developing countries.

To induce more banks to bid, we believe future debt exchanges will require added enhancements of the new debt. The most obvious enhancement would be some sort of guarantee of interest. A full guarantee of all interest would be prohibitively expensive, and we believe is not needed. Rather, a rolling guarantee say of several years' interest. Each year interest is paid, the guarantee rolls forward another year. If the country fails to pay interest, then the guarantee is called upon and a lender is certain of interest being paid. The country then has time to resume payment of interest.

Such enhancement of these forms of debt exchanges raises a major question - Who will provide the guarantees to make such a program work? The LDC's do not have sufficient resources to purchase collateral for their principal and cover interest. Some assistance is needed to make this work.

Also, some sort of sensible criteria as to which countries qualify for the guarantees must be developed. This should certainly be related to performance, and perhaps require that the LDC provide part of the funds for such a program. If such a criteria is not developed, the guarantor could be overwhelmed by applicants.

We have never looked upon the debt exchange technique as a panacea for the LDC debt problem. We do believe that as banks become more familiar and comfortable with it, and as the technique is improved and modified, it will become a more useful option for managing debt.

ADVANTAGES TO THIS APPROACH

First, the plan can be implemented on a country-by-country basis. For example, we understand that Mexico is working on a somewhat similar proposal in which it would pledge some of its own foreign currency reserves to help fund the insurance of interest payments on lower coupon bonds that would be exchanged for existing Mexican debt.

The second advantage. Our proposal would provide essential cash relief to the debtor without adding to an already excessive stock of debt.

Third, bank capital would be cushioned. The plan does not impose an up-front reduction of loan principal. Thus it permits heavily exposed banks to avoid a crippling "hit" to their capital which in many cases would occur if they were to sell large amounts of LDC debt at prices approximating the secondary market quotations.

The fourth advantage—it preserves future options. Lenders would absorb the "hit" gradually by accepting reduced interest payments for a time. As and when the country recovered, interest could return to a market rate. Thus lenders retain their upside. And some loans would not be written off, the damage to the credit standing of the debtor countries would be minimized.

Fifth, there would be no free riders. Unlike the situation today where banks can avoid new money contributions but continue to receive normal interest payments, in our proposal all creditors would receive any negotiated lower rate of interest. No creditor could take advantage of a free ride.

And sixth, Mr. Chairman, there would be incentives for policy reform. We believe that the proposal would do more than the present debt strategy to encourage debtor countries to presevere in a program of economic reform. This is because the plan offers the "carrot" of predictable debt relief—in effect, a light at the end of the tunnel. But it keeps the "stick" of the withdrawal of concessions and, most significantly, the withholding of new money.

Now the approach I've described is really a framework for negotiation. In particular, it could never be described as a "bailout" of the banks. If the interest rate concessions by banks and the bank funded portion of the insurance pool were both relatively large, the residual liability of governments would be correspondingly small. Everything depends on the specific terms that would be negotiated in a specific country. The essential conditions for success of the negotiation, however, are, first, that the terms would not be so onerous that banks would lack the ability or motivation to participate; and second, that the contribution by banks would nevertheless be sufficient to materially help debtor countries to recover; and third, that governments would be comfortable that their contingent liability was justified by public policy objectives. Those are the three constraints that any successful negotiation must respect.

In fact, there should be no addition to the liability of governments beyond what is already implicit at the present time. This is because the contingent back-up of the insurance pool would be unlikely to be drawn upon except in circumstances so extreme that governments, as a practical matter, would be required anyway to

provide emergency backing for their banking systems. The advantage in providing an explicit commitment is that it creates the certainty needed to enhance system confidence. This can only be provided by governments through announced undertakings. The increased confidence thus created—and this is a point I want to emphasize strongly—would be of tangible value to banks and would, we believe, motivate their cooperation and increased contribution to an enhanced debt strategy. Government back-up of the insurance pool is the most efficient way we could think of to induce banks to do more.

So, Mr. Chairman, to sum up:

First, our proposal fits with a case-by-case approach and should be viewed as a new element in a collection of evolving debt strategies.

Second, it is based on a workout principle which assumes that in many important cases debt forgiveness is not needed but that banks should contribute to LDC recovery by accepting a period of reduced interest payments in preference to concerted new money packages which, as we all know, are increasingly difficult to justify to supplies of bank capital.

Third, both the loan principal and the reduced rate of interest must be assured. The prevailing open-ended uncertainty as to the value of LDC debt significantly weakens the capacity of banks to contribute as much as they otherwise might to the resolution of the debt problem.

Fourth and finally, Mr. Chairman, our proposal described a framework for negotiation which would permit governments to participate in such a way as to satisfy public policy objectives without relieving banks or debtor countries of their responsibility to make a fair contribution.

Thank you very much and I apologize for having gone a minute or two over my time.

[The complete prepared statement of Mr. Nicholson follows:]

AN APPROACH TO DEVELOPING COUNTRY DEBT

Testimony

by Peter J. Nicholson

Senior Vice President

The Bank of Nova Scotia

Before the

Subcommittee on International Finance and Monetary Policy

Committee on Banking, Housing and Urban Affairs

U.S. Senate

Washington, D.C.

August 4, 1988

SUMMARY

Objectives

1. To increase financial resources available to promote growth in middle-income LDCs.

2. To reduce uncertainty as to the value of existing LDC debt in the banking system.

Key Features of Proposal

1. Negotiated reduction of interest payments.

2. No write-off of loan principal.

3. Principal guaranteed by zero-coupon U.S. government bonds.

4. Bank-funded, government-backed insurance of (reduced) interest payments.

5. New short-term lending by banks; medium- and long-term lending from official sources.

6. Involvement of a special "facility" (under auspices of IMF/World Bank) to assist administration of the plan.

Advantages

1. Case-by-case; fits with other elements of debt strategy.

2. Relief for debtor without increase of debt load.

3. Bank capital is cushioned. ("Hit" is phased through reduced interest income rather than asset write-down.)

4. Future options are preserved. If the debtor recovers, loans can revert to market rates.

5. No "free riders" -- all creditors receive (negotiated) lower interest payments.

6. Strong incentives for policy reform -- both a "carrot" and a "stick".

7. Proposal is a framework for negotiation which facilitates equitable sharing of contribution by creditors and governments.

AN APPROACH TO DEVELOPING COUNTRY DEBT

Peter J. Nicholson, Senior Vice President
The Bank of Nova Scotia, August 4, 1988

It is a privilege to have been granted an opportunity to put before this sub-committee the views of The Bank of Nova Scotia as to what, in our view, would be a constructive new approach to the chronic problem of LDC debt.

The plan of my remarks is to begin with a little background on Scotiabank and on our involvement in the debt issue. I will describe briefly the motivation for our approach to the debt problem and will outline the key features of a proposal. (More detail is provided in a paper attached to this testimony.) Finally, I will outline the specific advantages of the proposal and explain why, in our view, it merits the support of governments.

The Bank of Nova Scotia is the fourth largest bank in Canada with assets of approximately U.S. $58 billion, about the same size as Bankers' Trust. Although we have a network of more than 1,000 branches from coast to coast in Canada, roughly half of our business is generated abroad in some 45 countries where we are represented. We have had a long and successful involvement in the United States dating from 1885 when we set up an office in Minneapolis, a dozen years before we were even established in Toronto. Today, we are represented in eight cities throughout the continental United States and have earning assets associated with the U.S. of approximately $9.1 billion or about 17% of our total.

Scotiabank's gross exposure to the group of highly indebted middle income countries (essentially the Baker-17 group) is $3.5 billion. Canadian banks as a group have lent $17.6 billion to these countries, so we represent just under 20% of Canadian bank exposure. Canada's banks account for roughly 6.0% of total commercial bank lending to the Baker-17 group.

Relative to the size of our economy, this is about twice the exposure of U.S.-based banks and reflects the strong international tradition of Canada's banking system. Like other Canadian banks, Scotiabank has steadily built its reserves against LDC exposure. These will exceed 40% of that exposure by our fiscal year end on October 31st.

With this as background I will now turn to our thoughts on the debt strategy. We have always shared the concensus, clearly articulated by Secretary Baker in Seoul in 1985, that the LDC debt problem could not be resolved without a resumption of strong growth in the debtor countries -- roughly five to six per cent a year on average. The flaw in the official debt strategy is that it has proven incapable of stimulating the financial resource flows needed to regenerate adequate levels of growth in the middle income LDCs. We are convinced that it is very unlikely that this situation will change unless some fundamentally new elements are added to the strategy.

Because of the sheer scale of the debt problem, it has economic and political significance which make it much more than a banking problem. But at least in its banking aspects we view the problem as a big workout, no different in principle than the workouts we have often faced with domestic commercial borrowers in circumstances where simple foreclosure is not a practical option. In those cases, a lender sits down with the customer and negotiates a set of conditions calculated to restore financial health. Typically these involve a period of reduced debt service, often including reduced interest payments, geared to the borrower's ability to pay. Performance conditions will usually be attached. The prevailing orthodox debt strategy contains elements of this approach -- e.g., re-scheduling of principal and new lending to cover emergencies. But its mechanics are breaking down and, despite five years of world growth, it has not nearly met expectations for recovery in the LDCs. While it is not logically impossible that the present strategy --

with some fine tuning -- may still work, both experience and reasoning suggest that more will be needed. It seems obvious to us that new approaches should at least be seriously considered.

Our proposal was designed with two primary objectives in mind: first, to provide cashflow relief to debtors in amounts sufficient to help re-ignite growth but within the capacity and willingness of commercial banks to provide; and second, to remove some of the uncertainty associated with the value of LDC debt and thus increase confidence in the international banking system. In outline, our approach has six principal elements:

1. Reduced Interest Rate: Creditors would negotiate a possibly reduced rate of interest with a particular debtor country. The negotiated rate would be geared to some concept of "ability to pay". It might be subject to periodic adjustment back toward a market rate as the country's creditworthiness recovered.

2. No Write-Off: The principal amount of the debt would be kept intact though no repayments might be scheduled for several years. Relief for the debtor country would be in the form of reduced interest payments. This is where the cashflow bind is occuring now since principal repayment has already been postponed for many years in virtually all cases.

3. Zero-Coupon Guarantee of Principal: Loan principal would be guaranteed by the pledge of a zero-coupon U.S. government bond as collateral. This might be purchased: (a) using foreign currency reserves of the debtor country (e.g. as Mexico has done); or, (b) if reserves were insufficient, with the help of special lending by international financial institutions.

4. Intetest Insurance: Any reduced interest payments negotiated in the first step would be insured. The insurance would be provided by a pool of funds contributed, up-front, by the lending banks in proportion to their exposure to the country in question. To give this self-insurance feature complete credibility, the bank-funded pool would be ultimately backed by industrial country governments. This guarantee would probably be made through auspices of the World Bank/IMF Group.

(Example: The insurance scheme would work this way. Suppose the country were originally paying 8% on its debt and the banks agreed to a 2% reduction for a period. The purpose of the insurance would be to guarantee payment of the 6% residual rate of interest. If some unanticipated catastrophe made it impossible for the country to pay more than, say, 3% in a particular year then the insurance pool would be tapped to make up the shortfall of 3% until the crisis passed. These make-up funds would be drawn first from the bank-funded pool and only if this were exhausted would the government-backed guarantee come into play.)

5. New Money: In addition to the reduced interest burden, there will still be a requirement for new lending. Commercial banks would be expected to maintain short-term lines of credit for purposes such as trade finance and bridging of project loans. It is clear that medium and longer term lending to countries for balance of payments purposes is not an appropriate activity for commercial banks. Therefore, until a country regains its ability to tap the private bond and equity markets it must rely on loans from official sources including export credit agencies, the development banks and the IMF.

6. An International Facility: Implementation of this approach would almost certainly require the creation of a "facility" within the World Bank/IMF Group. The facility would administer the back-up guarantee of the insurance pool and would provide objective expertise in helping to negotiate reasonable interest rate reductions. Most important, the facility could play a key role in helping to design programs of economic policy reform in the debtor countries and would monitor progress toward agreed targets.

A number of specific advantages of this approach merit emphasis:

1. Case-by-Case: The plan can be implemented on a country-by-country basis. For example; we understand that Mexico is working on a similar proposal in which Mexico would pledge some of its own foreign currency reserves to help fund the insurance of interest payments on lower coupon bonds that would be exchanged for existing soverign debt. Our proposal is not designed necessarily to be an all-encompassing approach to the debt problem. But we believe it would be one significant new element in a "menu of strategies" ranging from new money packages, through debt swaps of various kinds, to debt discounting facilities of the sort proposed by Mr. James Robinson of American Express.

2. No increase in debt load: Our proposal would provide essential cash relief to the debtor without adding to an already excessive stock of debt.

3. Bank capital is cushioned: The plan does not impose a large up-front reduction of loan principal. Thus it permits heavily-exposed banks to avoid a crippling "hit" to their capital which in many cases would occur if they were to sell large amounts of LDC debt at prices approximating the secondary market quotations.

4. Preserves future options: Lenders would absorb the "hit" gradually by accepting reduced interest payments for a time. As and when the country recovered, interest could return to a market rate. Thus lenders retain their upside. And since loans would not be written off, the damage to the credit standing of the debtor countries would be minimized.

5. No "free riders": Unlike the situation today where banks can avoid new money contributions but continue to receive normal interest payments, in our proposal all creditors would receive any negotiated lower rate of interest. No creditor could take advantage of a free ride.

6. Incentives for policy reform: We believe that the proposal would do more than the present debt strategy to encourage debtor countries to persevere in a program of economic reform. This is because the plan offers the "carrot" of predictable debt relief -- in effect, a light at the end of the tunnel. But it keeps the "stick" of the withdrawal of concessions and, most significantly, the withholding of new money. The greater direct involvement of the official financial institutions further increases the discipline that could be applied.

Despite the foregoing advantages, the question will inevitably arise as to why creditor country governments should participate in such a scheme. There would of course be no reason to participate unless a government were persuaded of the public policy objectives that would be served by a resumption of strong growth in the middle-income LDCs. I don't need to review the objectives related to trade enhancement, encouragement of responsible democracies and enhanced financial system stability. Accepting that there is a rationale for greater government involvement, the key issue is to evaluate the merits of our proposal as a framework for structuring that greater involvement.

It is important to review how the contributions would be shared in our proposal. The banks contribute by way of reduced interest receipts; funding of the insurance pool; and through maintaining short term financing for the debtor countries' trade. Creditor country governments contribute through the ultimate back-up of the interest insurance feature and through facilitating new medium- and long-term lending by the international institutions. For their part, debtor countries must pledge to sustain vigorous programs of policy reform. This would include, in particular, strong measures to restore investment growth, even at the expense of continued restriction on consumption.

The approach I have described is really a framework for negotiation. In particular, it could never be described as a "bail out" of the banks since the contingent liability accepted by governments will depend first on the size of the interest rate concession negotiated between banks and debtor countries; and second, on the size of the bank-funded insurance pool. If the interest rate concessions and the funded portion of the insurance pool were both relatively large,the residual liability of governments would be correspondingly small. Everything depends on the specific terms that would be negotiated. The essential conditions for success are that: (a) the terms would not be so onerous that banks would lack the ability or motivation to participate; (b) the contribution by banks would nevertheless be sufficient to materially help the debtor countries to recover; and (c) governments would be comfortable that their contingent liability was justified by public policy objectives.

In fact, there should be no addition to the liability of governments beyond what is already implicit at the present time. This is because the contingent back-up of the insurance pool would be unlikely to be drawn upon except in circumstances so extreme that governments, as a

practical matter, would be required anyway to provide emergency backing for their banking systems. The advantage in providing an explicit back-up commitment is that it creates the certainty needed to enhance system confidence. This can only be provided by governments through announced undertakings. The increased confidence thus created would be of tangible value to banks and would, we believe, motivate their co-operation and increased contribution to an enhanced debt strategy.

So to sum up:

1. Our proposal fits with a case-by-case approach and should be viewed as a new element in a collection of evolving debt strategies.

2. It is based on a workout principle which assumes that debt forgiveness is not needed but that banks should contribute to LDC recovery by possibly accepting a period of reduced interest payments in preference to concerted new money packages which are increasingly difficult to justify to suppliers of bank capital .

3. Both the loan principal and the reduced rate of interest must be assured. The prevailing open-ended uncertainty as to the value of LDC debt significantly weakens the capacity of banks to contribute as much as they otherwise might to the resolution of the debt problem.

4. And finally, our proposal describes a framework for negotiation which would permit governments to participate in such a way as to satisfy public policy objectives without relieving banks or debtor countries of their responsibility to make a fair contribution.

Thank you very much. I will be pleased to try to answer any questions you may have.

ANNEXES

- A Proposal Regarding Developing Country Debt, March 15, 1988

- Attitudes to the LDC Debt Problem; (Background Note) by Geoffrey Holt, International Economic Advisor, Scotiabank August 2, 1988

A PROPOSAL REGARDING DEVELOPING COUNTRY DEBT

The Bank of Nova Scotia

March 15, 1988

THE PROPOSAL IN SUMMARY

1. Interest Reduction: Debt relief would be provided by a negotiated reduction of interest payments to all lenders in respect of existing debt of financially troubled LDCs other than debt associated with trade credit and interbank lines. The latter would be on normal commercial terms.

2. Ability to Pay: The amount of interest reduction would be related to a reasonable burden relative to exports and to the size of the debtor economy. The determination of "reasonable burden" would be made on a country-by-country basis and in conjunction with the multilateral financial institutions (i.e., World Bank, IMF, etc.)

3. Limited Lender Liability: The amount of interest concession would be subject to a negotiated limit. If, for any reason, there was a further shortfall in interest payment, it would be contributed by an insurance fund (described below) in the form of a make-up payment to the lender.

4. Insurance Fund: The insurance fund would be created and managed under auspices of existing multilateral financial institutions (e.g., the World Bank). It would be capitalized by lenders in some proportion to exposure and in a total amount to be negotiated.

5. Principal: Repayment schedules for debt principal would be extended or shortened as needed in light of the cash flow position of borrowers. Principal would be collateralized by zero coupon bonds issued by the US government and perhaps by other hard currency countries as well.

6. Securitization Option: The assurance of interest and principal payments would make LDC debt liquid. It would permit the debt to be packaged as readily marketable securities and would facilitate the re-entry of LDC borrowers to world capital markets.

7. New Money: A capital increase for the World Bank is essential to permit the substantial requirement for immediate new lending to finance economic development in the debtor countries.

8. New Investment: Opportunities for debt to equity swaps should be exploited to the greatest possible degree. Governments of debtor countries must be prepared to liberalize domestic equity markets and opportunities for foreign investment.

9. Discipline: The proposed approach would be overseen by the multilateral agencies under the leadership of the World Bank/IMF. Incentives for responsible debtor behaviour would be provided by: the interest concession (it could be reduced/withdrawn); the promise of new multilateral funding; and continued availability of trade finance and interbank lines.

Senator SARBANES. No, no. It was very good testimony. We appreciate it. Mr. Rona.

STATEMENT OF PETER RONA, PRESIDENT AND CEO, IBJ SCHRODER BANK & TRUST CO., NEW YORK, NY

Mr. RONA. Thank you, Mr. Chairman. I would like to summarize my testimony instead of reading it, by simply describing its salient points.

Senator SARBANES. The full testimony will be included in the record by all of the witnesses.

Mr. RONA. Essentially, the major points of my testimony are that the Baker plan made two major assumptions, neither one of which proved to have been experienced in subsequent events.

The first assumption was that if sufficient new moneys would be lent to less developed countries, a so-called adjustment process would somehow set things right in due course. This has not happened.

The second assumption was that it was right and proper to keep the commercial banks center stage in the entire mechanism for developing a solution to the problem. This increasingly looks like a questionable assumption.

Now why have these two issues not worked out?

In my testimony I make mention of the fact that had the Baker plan worked, it would have been quite an historical precedent. At no time in past restructurings in the some 150-year history of Latin American restructurings have approaches of that nature, in fact, borne particularly productive fruit.

The essential problem today with the less developed country debt is that the less developed countries are very seriously overleveraged. The debt to equity ratios that we are seeing, and I included some calculations in here, are simply unsustainable. Having given rise to capital costs that these countries are shouldering that are uneconomic, there are no legal economic enterprises with which one can derive the kind of returns that would be needed in order to service these kinds of capital costs.

DEBT TO EQUITY RATIO

Prior to World War II, assuming just as a hypothetical example a roughly 10-percent rate environment, on the basis of a debt to equity ratio that was taking place in the less developed countries in terms of foreign flows, we had $1 worth of borrowings taking place versus $3 worth of equity investments taking place in the form of direct investments in the less developed countries. That figure has just about turned around $4 worth of debt, $1 of equity by 1982, when the Mexican crisis erupted and is now in the neighborhood of $7 of debt to $1 of equity in the case of the Latin American countries. And that burden lies, in my judgment, at the heart of the problem. It is compounded by a relatively new phenomenon, not much experienced in prior periods, although not totally absent, which is capital flight. In the years preceding 1982, we were seeing something like 50 cents per every dollar of new loans leaving Latin America in the form of flight money.

Now the compounding effect of that on the debt to equity ratio that I am describing here is exponential, because in effect, what is happening here is that 100 cents worth of debt has to be serviced whereas, in fact, only 50 cents worth of the foreign resources are invested in the economy.

This capital flight issue is seldom talked about and there are not very many proposals developed either by this country or by the foreign countries that actually address this question. Yet it seems quite unlikely to me that absent a radical reversal of the capital flight issue there is any viable solution to the problem. This is an element that simply is not very much focused on, simply because of the magnitude of the issue.

Now from the outset, from 1982, there was less unanimity among Europe, Japan, and the United States than may have met the eye. Both Europe and Japan followed American leadership, European banks, Japanese banks, all contributed under the American approach of providing new moneys and participated in these plans with varying degrees of confidence in its ultimate success.

The Europeans very quickly took what I would regard a very classic traditional European approach to the problem and started aggressively to write off the Latin American debt. In that, they were alone. The Japanese didn't do that. The English-speaking world basically didn't do that.

I should emphasize that that European response is very much in line with European theory about banking. So it's a basic notion about banking that drove that response, namely, that the importance of balance sheet integrity exceeds the importance of the earnings statement. Therefore, in order to maintain public confidence in the solvency and integrity of the banking system, the quality of the balance sheet must be protected as an utmost, first priority and not the income statement. The income statement is a secondary consideration.

That general European policy led, of course, the Germans, Swiss, Scandinavians, et cetera, et cetera, to start writing off at a level which by 1986 basically meant that this group of banks had written off something like 70 percent of their LDC exposures.

By that time, the European banks were more or less openly saying that the LDC debt crisis was an American problem.

And that is where we are today. That is their basic attitude, inwhich they are trying to be perhaps helpful, perhaps trying to prevent confrontations, but they no longer regard it as a fundamental problem facing them. The issue becomes very important when you couple that with the new capital requirements which is perhaps somewhat outside the scope of the immediate topic of the hearings, but it becomes critically important to them when those two issues are in focus.

The Japanese banks, the Japanese Government followed American leadership and thought it inappropriate even to raise alternative proposals or to contribute to alternative suggestions to the American approach.

That position by the Japanese banks started to break about a year ago, when—slightly over a year ago, when the first proposal by Senator Bradley was circulated, which received a rather favorable response from the Japanese banks at the time. You will recall

A PROPOSAL REGARDING DEVELOPING COUNTRY DEBT

The prevailing approach to the developing country debt problem which has been based on repeated reschedulings and "involuntary" new lending is leading to a dead end. The approach, which has been dubbed "muddling through" even by it's advocates, was at best designed to buy time in the hope that the debtor countries would spontaneously recover and "grow out of the problem." Despite five years of general global economic expansion, this has not happened. The Bank of Nova Scotia has prepared a nine-point proposal as a basis for a new approach which would afford relief and hope to debtor countries. It would also go far to restore stability to the world financial system which is menaced by the overhang of almost US$500 billion of debt owed by some 17 heavily indebted developing countries.

There is widespread if not universal agreement on two basic objectives: (i) to re-establish strong growth in the developing countries as the only fundamental means to resolve the debt problem; and (ii) to maintain confidence in the global financial system throughout the difficult period of transition until LDCs are once again creditworthy. Disagreement arises among banks and between banks and government, regarding the best means to achieve these objectives.

The debt problem of developing countries is not moderating. At best, some indicators point to a stalemate -- e.g., the interest to export ratio has declined slightly, even though the debt to export ratio has risen. But the positive side of the story reflects both the steady decline of interest rates and five years of relatively strong growth in the industrialized countries. Such favourable conditions were confidently believed in 1983 to be sufficient to substantially reduce the scale of the problem by now. In fact, it has shown no significant improvement. And in light of the weakness in investment in most LDCs, the fundamental economic capacity of the debtors appears to have deteriorated, an ominous circumstance which has prompted a number of warnings from the World Bank.

The debt problem continues to cast a pall not only over the financial system, but also over trade prospects of countries -- e.g., both Canada and the US have swung from positions of merchandise surplus to large deficits with most of the major debtor countries. This translates into lost jobs here at home. It has been a major factor sustaining the US trade deficit and thus has been an important indirect cause of the volatile conditions in global financial markets. The LDCs have borne by far the heaviest brunt of the problem. Many now have real per capita incomes much lower than a decade ago. Their democracies, often fragile in the first place, are even more tenuous. The political pressure to default on debts has been increasingly difficult to resist.

New capital inflows to the major debtors have slowed to a trickle. In fact, the IMF made a net contribution of zero to the "Baker group" of 15 most heavily indebted countries in 1986 and when the figures are all in may prove to have been a net taker of funds in 1987. And while the World Bank has made fairly significant new commitments, actual disbursements have been slow. Meanwhile, some governments have been reluctant to approve the necessary new capital for the development banks to permit their lending to expand substantially.

Commercial banks have naturally been reluctant to extend new loans to LDC borrowers. The debtor countries are uncreditworthy, yet banks are expected to lend new funds at a declining interest margin, precisely the reverse of the usual relationship between risk and reward. Moreover, the regulatory authorities require provisions against new debt that ensures a loss on the income statement. And bank stock prices are penalized in direct proportion to LDC exposure relative to capital. These factors are responsible for the growing difficulty of negotiating "new money" deals for LDC debtors.

The foregoing analysis of the situation may be summarized as follows:

- The debt problem has not moderated fundamentally despite almost five years of growth in industrialized countries and declining interest rates.

- The prevailing conceptual approach to the problem as enunciated by US Treasury Secretary Baker in 1985 correctly identified LDC growth as the only real solution but was unreasonably optimistic in assessing the prospects for new lending (beyond a defensive minimum) by commercial banks. Governments meanwhile have failed to back the multilateral lending agencies to the required extent. Capital, in anything close to the required amounts, has not flowed.

- The necessary conditions for growth in the LDCs have therefore not materialized. The situation of these countries is highly vulnerable to rising interest rates, protectionism, or lower world economic growth.

The analysis suggests that a fundamental solution to the debt problem must be urgently sought. It should be based on the following four principles.

(i) Debt Relief: Most of the highly indebted countries cannot mobilize the investment needed for economic recovery so long as they must devote 35%-40% of export revenues to interest on old debt and focus domestic policy on maximizing the trade surplus. A lower interest burden is a prerequisite for a return to creditworthiness.

(ii) New Money: Substantial new flows of external capital -- beyond trade credit and beyond amounts needed simply to keep debt service current -- are required to permit economic recovery of the LDCs.

(iii) Incentives and Conditions: The new approach to the debt problem must be designed to provide incentives for responsible policies in debtor countries. (This implies a continued strong element of case-by-case treatment.)

(iv) Joint Responsibility: Banks and governments of both lending and borrowing countries share a responsibility to overcome the debt problem.

These principles suggest an approach to the debt problem based on the following elements:

1. Interest Reduction: Debt relief would be provided by a negotiated reduction of interest payments to all lenders in respect of existing debt of financially troubled LDCs other than debt associated with trade credit and interbank lines. The latter would be on normal commercial terms.

2. Ability to Pay: The amount of interest reduction would be related to a reasonable burden relative to exports and to the size of the debtor economy. The determination of "reasonable burden" would be made on a country-by-country basis and in conjunction with expert opinion from the multilateral financial institutions (i.e., World Bank, IMF, etc.)

3. Limited Lender Liability: The amount of interest concession would be subject to a negotiated limit. If, for any reason, there was a further shortfall in interest payment, it would be contributed by an insurance fund (described below) in the form of a make-up payment to the lender.

4. Insurance Fund: The insurance fund would be created and managed under auspices of existing multilateral financial institutions (e.g., the World Bank). It would be capitalized by lenders in some proportion to exposure and in a total amount to be negotiated.

5. Principal: Repayment schedules for debt principal would be extended or shortened as needed in light of the cash flow position of borrowers. Principal would probably be collateralized by zero coupon bonds issued by the US government and perhaps by other hard currency countries as well.

6. Securitization Option: The assurance of interest and principal payments would make LDC debt liquid. It would permit the debt to be packaged as readily marketable securities and would facilitate the re-entry of LDC borrowers to world capital markets.

7. New Money: A capital increase for the World Bank is essential to permit the substantial requirement for immediate new lending to finance economic development in the debtor countries.

8. New Investment: Opportunities for debt to equity swaps and other elements of the so-called "menu of options" should be exploited to the greatest possible degree. Governments of debtor countries must be prepared to liberalize domestic equity markets and opportunities for foreign investment.

9. Discipline: The proposed approach would be overseen by the multilateral agencies under the leadership of the World Bank/IMF. Incentives for responsible debtor behaviour would be provided by: (i) the interest concession (it could be reduced/withdrawn); (ii) the promise of new multilateral funding; and (iii) most importantly, continued availability of trade finance and interbank lines.

This approach to the debt problem addresses each of the principles set out in the previous section. It provides for significant debt service relief; new money; the stability of the financial system; incentives for constructive policies; and a fair sharing of cost. In this latter regard, the proposal includes a number of elements -- e.g., the amount of interest concession by lenders, and the capitalization of the insurance pool -- that can only be determined through negotiation. The purpose of the proposal is to describe a framework around which to structure a negotiation. Several features of the proposal deserve emphasis.

Interest Relief: This is the most effective way in which banks can contribute to a solution. Lower rates provide direct cash relief to debtors and thus reduce new money requirements. The amount of concession might not simply be forgiven outright. It might be made up, wholly or partly, in local currency entitlements for re-investment. This latter feature would have to be subject to negotiated conditions which would respect monetary policy concerns in the debtor country since the translation of interest obligations into local currency could be highly inflationary. With this feature, if and when the country recovers, lenders could share in the upside. Finally, by maintaining short term interbank lines and trade financing on a normal commercial basis, the proposed approach provides an incentive for banks to continue to supply the type of credit for which they are most well-suited.

Interest Insurance: The insurance pool would cover only an unanticipated shortfall in interest payments below the general reductions negotiated by the parties. The concept of a global insurance fund enables risks to be pooled. Lenders would contribute to the pool in proportion to their exposure and in lieu of taking further provisions. (The absolute size of the pool would have to be negotiated.) The insurance pool would serve to reduce inequalities arising from different national regulatory systems since contributions to the pool would effectively create a common reserving policy. Since credibility of the insurance fund would be the key to re-establishing confidence in the financial system, it must be established under the aegis of the multilateral institutions and ultimately be backed by them.

Debt Principal: It is important to ensure that agreed payments of loan principal, even if rescheduled over a long term, are ultimately secured. This could be done by pledging as collateral, zero-coupon US Treasury Bonds of long maturity and with redemption value equal to the loan principal to be secured. (Bonds of other hard currency countries could also be used.) These bonds might be purchased by the debtor countries with existing foreign currency reserves as Mexico has done. This would not be feasible for all debtors in the required amounts. The purchase of the collateralizing bonds might be undertaken on behalf of the LDCs by the World Bank or an affiliate. The latter could fund the purchase through the issue of special securities to industrialized countries in surplus positions. This would have the added indirect benefit of recycling funds to finance the US deficits.

At today's rates, for example, $100 billion of LDC debt could be collateralized by a purchase of roughly $15 billion of 30-year zero-coupon bonds. This feature does not imply that there would be no amortization of principal for 30 years. Earlier repayments (roll-overs) could be required as debtors recovered and the need for interest concessions ceased. The suggested collateralization of principal is intended only to provide an ultimate back-stop in order to isolate the debt problem to the issue of interest flows. Interest payments would then be addressed by negotiated reductions and by the insurance fund. In the major of cases there is no need, either from the viewpoint of the debtor or creditor, to actually write-off principal.

Securitization: The real significance of the assurance of principal and (reduced) interest payment is that the existing LDC debt becomes a liquid asset on the balance sheets of creditors. The loans could either be held to maturity or repackaged and sold as securities at a discount that original creditors were prepared to accept. At present, the various attempts to sell loans or to "securitize" LDC debt have been of very limited significance because: (a) there was no depth in the secondary market -- i.e., the assets have no liquidity; and (b) the required discounts were too steep to induce all but a few lenders to sell their loans.

The plan proposed here would overcome this problem and would likely lead to a deep and liquid secondary market in LDC debt. This is the real "market-based" solution that so many have advocated. It would have the further advantage of re-introducing a number of developing country "names" to the private capital markets thus paving the way for an eventual return to conventional private financing of their economies.

Focus on Existing Debt: It is sometimes suggested that approaches to the debt problem should aim to provide incentives for new commercial lending; for example, by providing (partial) guarantees. For a given commitment of resources, however, it is better to assure interest payments on old debt rather than on new. This is because: (i) decisions regarding old money have already been made. There is no risk of moral hazard or distortion of behaviour in respect of these funds as there might be with new lending decisions in the presence of insurance; (ii) it is old debt, not future debt, that has cast doubt on the stability of the financial system. This problem is addressed by shoring up the old debt; and (iii) insurance on new lending interferes with the return of debtor countries to normal commercial creditworthiness and is potentially an open-ended commitment hampered by bureaucratic oversight.

New Money: The proposed approach faces squarely the impracticality of continuing to rely on significant new money contributions from commercial banks. Piling on new loans at commercial rates, even if they could be coaxed out of banks, is not the answer for the most heavily indebted countries in today's circumstances. The banks can, in effect, contribute a fair share of "new money" through: (a) interest abatement on existing medium- and long-term debt; and (b) maintenance of trade and interbank lines on commercial terms. New money will nevertheless be needed to finance adjustment, balance of payment gaps and development projects. Such financing, except possibly on a bridging basis, should not be expected from commercial banks. Until the LDCs recover the confidence of private capital markets there is no alternative alternative to substantially increased lending by the IMF and the multilateral development banks. As the debtor countries recover they should begin

Case-by-Case: It is important that any approach to the debt problem retain flexibility to tailor the program to individual country circumstances. Under the plan advocated here, the amount of interest concession would be determined case-by-case on the advice of the IMF and World Bank in consultation with lenders and borrowers. To the greatest possible extent, any concession should be based on objective criteria in such a way that positive economic performance reduces the amount of concession but not so severely as to impair the motivation to improve. For example; there may be merit in relating maximum interest burden in part to a percentage of GNP (and not just to export figures) since no country would be motivated to deliberately depress output in order to minimize interest payments. Maximum required interest payments could also depend on world prices of certain key export commodities. These are important matters for negotiation.

Some will argue that any concessional approach will quickly become universalized and thus make impossible any separation of the "deserving" from the "undeserving." If concessions are based on objective criteria, the tendency to lowest common denominator is resisted. And of course the existing case-by-case approach has not avoided the pressure for each deal to incorporate the most favourable features of those preceding it.

Reforms in Debtor Countries: It is assumed that the debtors themselves have an incentive to introduce appropriate economic policies. Further discipline can be imposed by lenders' refusal to advance new funds and by the withdrawal of interest concessions. (In the present approach to the debt problem there are fewer "carrots" to be withheld and thus less effective discipline is possible.) The fact that the incentives and disincentives would be overseen by multilateral institutions adds an extra incentive since the debtor countries must deal with the World Bank and affiliates over the very long run. It must be acknowledged, however, that the threat of punishment by creditors is only effective as a deterrent. If the country persists in poor economic policies, the creditors' ability to impose harsher debt service will in fact be reduced since once cannot get blood from a stone. This frequently is the situation today. The plan proposed here, by creating light at the end of the tunnel, contains greater incentives for policy reform than the prevailing strategy of "muddling through."

Who pays? The lenders, primarily commercial banks, are first in line to contribute through: (i) cash concessions on interest rates. (Unlike the establishment of loss provisions, interest reduction affords relief to debtors and thus facilitates their economic recovery.); and (ii) capitalization of the insurance fund. (Failure of the debtor to pay even the concessional rate of interest would trigger a draw on the lender-financed insurance pool.)

The liability of governments would be wholly contingent, relating to: (i) ultimate back-up of the insurance pool. (This is analogous to the back-up of deposit insurance systems and is essential to restoring confidence in the banking system.); and (ii) shareholdings in the multilateral institutions which would be called upon to provide more medium- to long-term financing. Commercial banks would continue to provide new money at the short end.

The relative division of liability between creditor country governments and lenders would be determined by the size both of interest concessions and of the initial capitalization of the insurance pool. The larger these amounts, the greater the contribution of lenders relative to governments. The essence of the negotiations would be to arrive at a mutually acceptable trade-off that: (a) afforded foreign exchange relief to LDCs (the interest concessions) sufficient to significantly improve their growth prospects; (b) re-established confidence in the international banking system; and (c) left creditor country governments satisfied that their contingent liability was warranted in view of public policy objectives related to foregoing items (a) and (b).

Relationship to Baker Initiative: The proposal advocated here is put forward not in opposition to the "Baker initiative" but, on the contrary, as perhaps the most effective instrument with which to implement that initiative. In fact, the plan was designed specifically to overcome the "new money" problem which has proven to be the Achilles' heel of Mr. Baker's original proposal. The central idea is to negotiate the concessions required to permit the LDCs to grow out of their bind without increasing the exposure of commercial banks and worsening the debt load of the LDCs. A key advantage is that once restructured interest payments have been negotiated, all creditors to the particular country must make their contribution through a reduced stream of interest income until the country recovers sufficiently. Thus, no bank could opt out as is now the case with new money deals. Participation in the insurance pool would be voluntary -- and thus the plan is "market based" -- but those banks which opted out would still receive the negotiated (lower) rate of interest and would fail to have the assurance of interest and principal that is embodied in the concept and backed up by governments. Thus, the incentive to join would be powerful.

Probably the most widely-discussed alternative to the approach being advocated is to have the banks sell their LDC debt, at a steep discount, to a special agency of the multilateral institutions. The savings would be passed on as relief to the debtors. Discounts on the order of 50%, reflecting today's prices in the (thin) secondary market for LDC debt, have been suggested. It is preferable to base a concessional program on interest rate abatement without triggering a substantial loss on principal. When the country recovers, normal market interest payments can resume whereas principal, once forgiven, is gone forever.

The proposal being advanced here can achieve all of the economic benefits of loan sales to a multilateral agency but with much more modest involvement by such an agency. The proposal is nevertheless entirely compatible with an international facility to discount LDC debt. It would probably be helpful to create such a facility to provide an alternative for those creditors that wished to clean their slate of debt to certain countries and were prepared to pay the price up front.

The only significant shortcoming of the approach being advocated is the difficulty of negotiating its implementation. This would be a hopeless task were it not for the growing realization that the prevailing approach is: (a) breaking down in respect of its mechanics (i.e., new money packages cannot be equitably negotiated); and (b) exposing the financial system, the trading system and the LDCs themselves to continuing unacceptable costs. The time is ripe for a new conceptual approach that respects the interests of all parties.

Attitudes to the LDC debt problem

(Background Note prepared for U.S. Senate Subcommittee on International Finance and Monetary Policy by Geoffrey Holt, International Economic Adviser, The Bank of Nova Scotia).

2nd August, 1988

1. The LDC debt problem is not one problem but simply the aggregation of many. This plurality has been as true in the post-1982 work-out period as it was through much of the 1970s, when the greatly expanding use of commercial bank credit in the international system was widely viewed as a fitting opportunity for reconciling the diverse objectives held at that time by borrowers, lenders and national official policymakers.

2. When the sharply adverse turn in the global financial and economic environment in the early 1980s led to the sudden and wholesale reappraisals of the sustainability of sovereign borrowing, this same plurality of interests, and the potentially diverse capacities for recovery among debtors, inclined the search for solutions in the direction of piecemeal, case-by-case approaches, as opposed to large-scale negotiated plans for debt reconstruction.

3. Nevertheless, the aggregate amounts involved, both in terms of the global economic activity and trade thus afflicted and in terms of banking exposure to troubled sovereign borrowers, were, and remain today, of systemic proportions.

4. To the extent that any grand strategy has existed, this has evolved from the initial "firefighting" approach, of coping with crises as they build up, in the hope that time and some linked mixture of new funds and debtor policy progress would restore access to the financial markets. While somewhat refined by the articulation of burden-sharing principles in the 1985 Baker initiative, and while more recently supplemented at the margin with innovative financial techniques, the basic thrust has remained one of "muddling-through".

Continued

5. Judged in its own terms, muddling-through has succeeded in buying time. It has averted serious financial system rupture and it has enabled banks to make sizeable reductions in their exposure relative to capital and to build a large cushion of reserves against possible future loan losses.

6. Without belittling the energies and sacrifices directed to the debt problem for the past six years, it must nevertheless be clear that muddling-through has far from solved it. Market access has not been restored; very little differentiation among the class of afflicted debtors has come about; and despite the extensive rescheduling of principal, some of it into the next century, the constraints and distortions which ongoing debt service obligations place on many countries' external payments positions effectively stifle the chances of resources flowing into new domestic investments. Growth rates therefore continue to be generally depressed.

7. Rather than having been solved, the debt problem has been transformed. Both from the perspective of the debtor country awaiting renewed market-based finance and from the point of view of the commercial bank contemplating its asset allocation strategies, the world is an irrevocably different place from six years ago. Not only is the contractual medium-and longer-term bank credit now widely seen as an inappropriate vehicle for general purpose balance of payments finance; but also, the generally raised risk perceptions, related to the newer systemic uncertainties contained in the global capital markets, have inclined the banks away from their former traditional risk-transformation roles within the system. With the pressures of financial competition now shared increasingly with non-bank institutions, and increasingly spreading across national boundaries, the banks' business focus has sharpened towards the return on equity - a trend reinforced by the new risk-adjusted capital adequacy requirements of the regulators.

Continued...

8. This recent transformation in the global capital markets, encouraged by the trend of financial liberalisation in many countries, has been partly a consequence of the continuing muddling-through approach to LDC debt; this was by virtue of the diminished credit status of banks themselves and their quest for flexibility. In turn, the new styles of global finance are having a bearing on the muddling-through strategy. Because of the continuing scale of bank exposure, and because of the crucial inter-bank relationships applying to wholesale international banking, the debt problem remains a perceived flaw in the eyes of bank shareholders. Thus, at a time when market discipline is taking over from former regulatory protections, the greater scrutiny which shareholders - as important suppliers of bank capital - will want to exercise upon bank management will seem increasingly at odds with the involuntary allocation of assets (and the capital cover) which a perpetual muddling-through debt strategy may entail. Simultaneously, emerging disparities among banks, with respect to capital raising and provisioning capacities, have lessened the community of interest which debt management had relied upon earlier.

9. These shifts and tensions in the financial system imply that policymakers must assess the durability of the muddling-through approach with a more critical appreciation of its potential limits. During the surge of international lending in the 1970s, it was widely regarded by officials as being an efficient market-based approach to the allocation of the large pools of savings accumulating in the system. Since then, the international system has become even more market-oriented. But the corollary of the banking system being enmeshed in sovereign debt in the seventies, and of its slow extrication since the early eighties, is that this increasing market-orientation has been accompanied by strong, globally integrating movements of capital. The "contagion" which marked the sudden closing-off of credit to Latin American borrowers in 1982 has had its recent counterparts in the recurring system-wide reactions to the continuing global imbalance.

Continued...

10. The lesson must be that in an increasingly integrated and market-sensitive setting, no one constituency - "taxpayers", "governments", "banks" or whatever - can assume safe insulation from large systemic impairments such as the debt problem contains. "Private sector" and "public sector" risk are already intertwined. Market discipline and market incentives are highly desirable priorities and deserving of political support, but they will not operate in a vacuum. The markets have become central to the system, but the interests of the system still need affirming and this is a role which competitive market players are increasingly less likely to attend to. The major governments, however, still see their leadership role with regard to debt as being an essentially indirect, non-interventionist one, relying on "market solution" and moral suasion.

11. The LDC debt problem arose fairly and squarely out of system-wide developments in the 1970s. Today's more market-oriented system is less amenable to "grand solutions" than it was in the 1970s, but it seems unimaginative to suggest that no scope for initiatives lies between the two alternatives of grand solutions and doing nothing. The more modest objective should be one of improvement where achievable. The LDC debt problem offers aspects for just such improvement, given political leadership. By instituting mechanisms to ensure that debt servicing could be carried out at a pace such as to permit genuine growth among some of the troubled debtors, governments would have some prospect of seeing incentives, both in the financial system and in the debtor economies, working in a positive way.

that that proposal essentially involved the suggestion of interest relief for the less developed countries. Since that time, a number of other tentative approaches were made culminating recently by the Prime Minister's suggestions in Toronto.

Now, essentially what are the Japanese doing? The Japanese are stepping up governmental aid. The theory is that the governmental aid is the functional equivilent of flows of equity. Unless we are able to increase the flow of equity into the less developed countries, the chances of a solution to the debt problem are not realistic. Their willingness to do government and government-private enterprise linked equity flow promotional programs is a reflection of that belief.

Those numbers in that program are known to the committee, and so I won't go through the figures.

Second, the Japanese banks on the whole would like not to have, and in this area more or less that is the understanding of the Japanese Government, not to participate or not to propose schemes involving new money contributions. If, in fact, the hypothesis that debt, additional debt, does not help the LDC's is correct, any scheme involving further loans of this type is not a useful one. So they are looking for alternatives that would structure a solution that does not involve new moneys.

That desire for an alternative leads them to be strong supporters of debt to equity swaps. Once again, the same thing, more equity, less debt.

So the Japanese Minister of Finance has been rather liberal and supportive of Japanese bank proposals permitting them to convert their loan claims in these less developed countries into equity.

Third, the Japanese generally feel that commercial banks have a limited amount to contribute to development finance, and that limited amount is restricted to two specific areas. One is trade credit, where clearly the commercial banks have an important and proven role to play.

The second is project finance, where, again, commercial banks have a valuable function to perform.

Beyond that, commercial banks should not be involved in this type of lending.

I am sorry, I have gone over the time. Thank you very much.

[The complete prepared statement of Peter Rona follows:]

Senator SARBANES. Thank you very much, gentleman. We appreciate your testimony.

I think we will do 5-minute rounds, given the number of members that are present.

Mr. Wagner, I want to just ask a couple of specific questions about the Mexico transaction.

Mexico used, I think you said, about 500 million of its reserves in order to make this work; is that correct?

Mr. WAGNER. That is correct.

Senator SARBANES. And then you set out the figures over the long run, in terms of reduction in their outstanding debt and what they would save in interest payments over the 20-year period.

In the short run, what was the impact of the transaction?

IMPACT OF TRANSACTION

Mr. WAGNER. There is a savings of interest that would have been paid on the extinguished debt. The debt was reduced by $1.1 billion. Interest no longer will be paid on this debt. We estimate the savings to be $100 million a year.

Senator SARBANES. So in the short run, they laid out more out of their reserves. Suppose they had made the decision, as you said, to use the reserves for growth. You set out the three alternatives that they might have done.

In the short run, they actually laid out more then they picked up, in terms of being able to contribute to a growth strategy. Would that be correct?

Mr. WAGNER. Yes, they paid $500 million out in cash and bought 20-year zero coupon bonds to be used to repay the $3.7 billion of new debt due in 20 years. $1.1 billion of debt was gone. They no longer pay interest for that. And the immediate effect of that in year one is a reduction in the amount of interest they have to pay, because they don't have to pay interest on the $1.1 billion. Now the interest cost on the $500 million of zeroes would have to be paid in any event as this is the cost of paying the principal.

Senator SARBANES. Well, Mr. Nicholson, if I understand your approach, you try to take the interest payment down, in order to create a growth stream there without reducing the debt principal; is that correct?

Mr. NICHOLSON. Yes, that's correct.

Senator SARBANES. And why do you think that is a better approach than the one we have just done analyzing?

Mr. NICHOLSON. Well, Mr. Chairman, we felt it was really the most efficient way to contribute to solving the crisis we have now, which is a cash flow bind for the debtors. When you require a reduction of principal—that is, forgiveness—you immediately and permanently hit the capital of banks. You don't leave any up-side when the debtor eventually recovers. Since the debts were already rescheduled so that the payment of principal was very far in the future, you don't achieve any cash flow saving that you can't achieve just as well through a period of interest reduction.

So we thought our scheme was just a much more efficient way to achieve a given target of cash flow relief while maximally sustaining the integrity and the future prospects of bank balance sheets.

We thought you could buy more for your dollar with an approach geared that way. It is very much the philosophy of a conventional workout in a commercial lending situation.

Senator SARBANES. Now there is a lot of talk about new money and old money, and it is very hard, I think, sometimes to draw the line as to what is new money and what is old money, but I take it all three of you have an approach that instead of having a new flow of money go to the developing countries from the lenders, get some additional money by reducing in some way or other what they have to send back in terms of the existing arrangement. So it is that reduction that gives them some room for growth and not a new infusion of money to them.

First of all, is that a correct perception of your views and, if so, assuming that it is, what are the reasons that you come at it that way as opposed to new flows or any reason to think that there could be a new flow in these circumstances?

Mr. WAGNER. Well, Senator, we at Morgan are not opposed to new money programs, if they can work; however it's becoming increasingly difficult to get banks to participate in new money programs. The problem of covering the financial needs of a country is a big problem, and we are prepared to approach it from any angle that will help. If new money in sufficient amounts is available and will permit the country to grow, fine. Another route is to reduce the outflow of cash by reducing the interest rate by doing some sort of debt swap—either debt-for-debt or debt-for-equity. We are prepared to consider any way that will work.

The problem of a country's financial need is a cash flow problem and in attacking this problem, you do it by providing resources to the country. You can either do it by reducing what's paid out or by increasing the money paid in. When you reduce what is paid out, the principal isn't at issue. The banks have already postponed the payment of principal. We have granted long grace periods and long repayment periods on principal. What we are faced with is payment of interest.

Now we can get at the problem of either reducing the interest, as the Bank of Nova Scotia is discussing, or you can get some sort of swap working, where, if it is attractive it will take existing debt and swap it for new debt at a discount. And if you can do that on a basis that reduces the amount of debt outstanding, then your interest goes down, and it will go down permanently because the debt is gone. One can of course also swap for equity which will extinguish debt.

Mr. NICHOLSON. Mr. Chairman, if I might just add a couple of things. I think there are a couple of other reasons why the new money approach, relying on commercial banks, is not the best way to go. One has already been referred to by Mr. Rona—the role for commercial banks is at the short end of the spectrum; trade finance and project lending on a bridging basis. And that, I presume, the banks would continue to do. But the requirements for new money of a longer term create the free rider problem. People can decline to do their part and also, of course, it continues to build the debt stock, which, as Mr. Rona has said, is already unsustainable.

So for both those reasons, the free rider problem and the debt stock problem, we don't think that's the way to go.

WRITTEN STATEMENT TO THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

of the

U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

by

PETER RONA, PRESIDENT AND CHIEF EXECUTIVE OFFICER

IBJ SCHRODER BANK & TRUST COMPANY

THURSDAY, AUGUST 4, 1988

Good morning, gentlemen. The two questions I would like to address are:

1) Has the approach to the LDC debt crisis sponsored by the U.S. Treasury and the Federal Reserve worked, and if not, why not?; and

2) What alternatives have been proposed by the European and Japanese authorities and why?

In one sense one might regard the American approach, embodied in the "Baker plan", as a success. There is no question that our commercial banks, including the top nine that account for some 65% of total U.S. bank exposure to less developed countries are better equipped to face the loss inherent in their LDC loan portfolios than they were in 1982. But beyond this evident benefit the picture turns first murky and then starkly negative. Even for this relatively modest benefit, the banks paid a high price. Can there be any serious doubt that it is LDC loans more than any other factor that destroyed the price to earnings ratios of the leading American banks' shares causing their capital costs to rise to uncompetitive levels, and can there be any doubt that this factor, more than any other, brought about their loss of world leadership?

Beyond this, the time gained through additional lending to the LDC's seems not to have resulted in the kind of improvement in their economies that could lead to a resumption of their debt servicing let alone to sustained economic growth. The bleak circumstances and prospects facing the LDC's were fully described this past January in the report of the World Bank and there is nothing I need to add to that summary.

Had the "Baker plan" produced more tangible benefits, it would have set an historic precedent. The long history of external debt defaults, a history that for Latin America stretches back to over 150 years, is strikingly meager in examples of post default financing

bringing about a resumption of orderly debt service. To the contrary, the historical experience is that reliance on external borrowings for economic development has been highly hazardous. Overborrowing has occurred at least once every three decades or so, followed by partial or implicit default, followed by protracted and largely unsuccessful negotiations, followed by partial forgiveness - with some settlements as low as 7 cents on the dollar, followed by another cycle of exuberant borrowing. While much of the current crisis resembles previous ones, there are three important differences that largely explain the extraordinary severity of the current problem. I also believe that a correct understanding of these three issues might provide the basis for an eventual solution.

The first important departure is that after World War II, the mix of development finance increasingly shifted away from a ratio of about 3 dollars of direct investment, or equity, to each dollar of debt[1] to just about the converse. By the time the crisis broke out in 1982, LDC debt financings exceeded equity investment by a factor of 4 to 1[2] and for Latin America by a factor of nearly 7 to 1. (Table 1) This shift to debt, with its inherent requirement for the fixed payment of interest and principal regardless of the success or the cyclicality of the business, simply over-leveraged already undercapitalized economies.

1. Marilyn E. Skiles. Latin American International Loan defaults in the 1930's: Lessons for the 1980's? April 1988, Federal Reserve Bank of New York.

2. Table A40 "World Economic Outlook", April 1985, International Monetary Fund, Washington, D.C.

Table 1 See Table Attached

Table 1

Estimated net capital flight
cumulative flows during 1976-85
billions of dollars, minus sign indicates outflows

	Net direct investment inflows	Change in gross external debt	Current account balance	Change in selected gross foreign assets	Capital flight		
					Total	1976-82	1983-85
Argentina	4	42	-15	-4	-26	-27	1
Bolivia	0	3	-2	0	-1	-1	0
Brazil	20	80	-77	-13	-10	-3	-7
Chile	2	16	-16	-3	1	0	1
Colombia	2	10	-11	-2	0	0	0
Ecuador	1	7	-5	-1	-2	-1	-1
Mexico	11	75	-29	-3	-53	-36	-17
Peru	0	8	-6	-2	0	1	-1
Uruguay	1	4	-3	-1	-1	-1	0
Venezuela	0	26	10	-5	-30	-25	-6
Subtotal	40	270	-154	-33	-123	-93	-30
India	0	22	-8	-5	-10	-6	-4
Indonesia	2	27	-15	-9	-5	-6	1
Korea	0	40	-22	-6	-12	-6	-6
Malaysia	9	19	-12	-4	-12	-8	-4
Nigeria	2	18	-15	4	-10	-7	-3
Philippines	1	23	-16	1	-9	-7	-2
South Africa	-2	16	2	2	-17	-13	-4
Thailand	2	17	-17	-1	0	1	-1
Subtotal	14	181	-102	-18	-75	-52	-23
Total for 18 countries	54	451	-256	-51	-198	-145	-53

Source: *World Financial Markets*
March 1986. Morgan Guaranty Trust Company

The second factor was and is the extraordinarily high incidence of capital flight from the LDC's. During the eight years preceeding the Mexican crisis, an amount equal to nearly fifty percent of new borrowings left the recipient Latin American nations. The significance of this factor is, either a doubling of capital costs or a halving of the cash flow available for debt service, depending on the view point. Put differently, the recipient's economy must continue to service 100% of the debt even though only 50% of the proceeds were invested in it or, conversely, that much of the hard currency cash flow produced by the economy is being divested and therefore unavailable for productive reinvestment or for debt service. The attached table reflects the figures associated with both of these factors.

The combined effect of these two factors is, of course, exponential. Increased leverage when added to an effective doubling of debt costs, as a result of capital flight, resulted in a level of capital costs for the LDC's that would be unsustainable for just about any company or any economy in the world. Thus, assuming a 10 percent interest rate throughout this hypothetical example, the average cost of contractual capital under the pre-World War II ratio of 3 dollars of equity for every dollar of debt comes to 2.5%. With the ratio deteriorating to 4 dollars of debt to every dollar of equity, capital costs more than triples to 8% and when the effect of the capital flight described above is factored in, the figure rises almost to 14%. This analysis is of course in dollar terms and the cost in local currency terms can be a multiple of this cost depending on currency devaluations and inflation.

In my opinion it follows that there simply aren't any "policy choices" that can bring about any sort of an "adjustment process" to overcome or sidestep the body-blow of these two factors.

The third difference is that the overwhelming bulk of past LDC credits were bond issues, whereas the financings of the 1960's and 70's were largely commercial bank loans. Commercial bank lending to sovereign borrowers has significant disadvantages compared with bond flotations and these disadvantages bear some examination.

The first of these disadvantages is contained in Walter Wriston's often quoted dictum about countries not going bankrupt, for it is precisely the absence of the remedies available to a creditor in bankruptcy that makes such lending uniquely hazardous. The illiquidity of the loan when coupled with the absence of any power to foreclose upon collateral leaves the lender without any meaningful means with which to influence the borrower to adhere to policies that lead to the repayment of the debt. In contrast, the bondholder can simply sell bonds, even at a loss, when the issuers' affairs take an unfavorable turn. The issuer has an incentive to prevent such sales since the immediate result is a rise in bond yields with a corresponding increase in future borrowing costs. The inability of the commercial lender to take such action reduces his means for insisting on sound economic policies and transforms the question of what is a sound policy from one validated by market prices to one that is determined by negotiation and debate between officials of the debtor, the IMF, the central banks and the lenders. Economic policy in any country is made in the crucible of the competing pressures of divergent constituencies. Since bank creditors, foreign central banks and the IMF do not represent a political constituency, their amorphous remedies, no matter how necessary, will often lack the concrete and immediate impact of a threatened strike, civil disorder or coup d'etat. Instead of a bond market, that will not lend new money and cannot be compelled to do so by any authority, because it simply dries up and disappears: we have banks that cannot disappear, that have committed their depsitors and investors funds. Therefore, they are seen as being unable to afford

not to lend. In short, the banks in lending to a borrower that cannot go bankrupt are also lending to one that has no immediately compelling reason to follow policies that safeguard his solvency.

The second disadvantage of commercial bank lending to sovereign borrowers is that the intellectual disciplines associated with lending, called credit skills, are largely inapplicable. Credit analysis revolves around the business enterprise rather than a country. They concern things like cash flows, leverage and asset values rather than GNP figures, trade statistics or the rate of domestic capital formation. There are no reliable techniques for reaching credit judgements on the basis of the latter because macroeconomic figures differ in their fundamental nature from those appearing on the balance sheets and income statements of enterprises. It is ultimately inappropriate to view, for example, central bank monetary reserves as if they were the equivalent of cash on hand, or to regard export revenues in the same light as after-tax earnings plus depreciation for the purpose of computing debt coverage ratios. There are, of course, occasional similarities and perhaps a few principles of general applicability, but to expect commercial banks to finance sovereign borrowers is a bit like asking a dentist to perform a heart transplant.

At the same time it is perhaps worth pointing out that commercial banks have a solid historic track record in two areas of relevance to the LDC's, namely, trade finance and project finance. In both of these areas banks have the pre-eminent expertise to understand and deal with the relevant facts and figures. In both cases they can secure important foreclosure rights, cash flows can be identified and insulated and asset values can be determined. Unfortunately, one of the many deleterious side effects of the current

crisis and its management has been the submerging of much of both trade and project finance by bringing such debts into sovereign risk restructuring. Paradoxically, therefore, the two areas where the commercial banks could make a significant contribution have been rendered largely unavailable to them in favor of a third one, sovereign risk lending where they are at a significant structural disadvantage.

Hopefully, this quick sketch of the causes of the problem will help illuminate the differences in approach among the U.S., Western Europe and Japan that have slowly grown more pronounced as the years passed by without any visible improvement in the situation.

There was probably less unanimity of opinion among the industrialized nations even at the outset than may have met the eye. However, it was not thought by anyone that emphasizing the differences was either useful or appropriate. The Swiss, German, Scandinavian, Dutch, French and Italian banks and authorities did not publicly question the original American thesis that the problem was one of LDC liquidity rather than solvency. They participated in the new loans, but almost immediately they adopted programs for writing off these debts. Thus, by the fourth year of the crisis, having written off more than half of their LDC loans some of the Europeans started to characterize the LDC debt crisis as "an American problem". There was strong consensus that the protection of bank balance sheet integrity is the foremost priority because public confidence in the financial system rests first and foremost on strong bank balance sheets. In contrast to the American approach, balance sheet strength is seen less as a function of capital to assets ratios and more in terms of asset quality. Thus, the movement to actually remove these assets through write-offs had few if any opponents even among politicians of differing political persuasions.

The Japanese, on the other hand, felt from the outset that the response to the crisis was a matter of governmental policy. The policy and political implications of any response were seen as more important than the immediate interests of the banks and as being of course beyond the competence or responsibility of bank managements. The Japanese Government in office since 1982 have chosen, until very recently, to accept and support the American initiatives and to abstain from even mentioning the possibility of alternatives in public discussions. I suspect that they were influenced by two considerations. First, they did not wish to add to existing friction between the U.S. and Japan by disagreeing with a policy in which the American authorities appeared to have such confidence. Second, with the burgeoning surpluses and strong domestic economic conditions, Japanese banks had remarkably few domestic credit problems and conditions were exceptionally favorable for deposit and asset growth. Earnings multiples of Japanese bank shares were rising in line with the rest of Japanese industry so that the magnitude of the problem relative to available resources was rapidly diminishing.

The Japanese, in observing both the letter and the spirit of the "Baker plan" to a degree far exceeding that shown both by the Americans and the Europeans have not been allowed to reduce their exposure through sales of their loans. Nor have they been able to increase reserves against these loans or to write them off. The guidelines up until March of this year allowed reserves for loan losses up to only 5 percent with only 1 percent being tax deductible and although the 5 percent was raised to 10 percent, the tax limitation has not been changed. At the present time Japanese banks can sell loans under the Mexican type zero coupon program and under debt to equity swaps, both subject to specific approval from the Ministry of Finance.

As a result of consistent Japanese response to new money requests on the one hand and their inability to reduce or write-off any of their exposures, except as noted above, Japanese bank exposure to the LDC's has just about doubled during the past 6 years whereas American and European exposures have grown much less. Matters came somewhat to a head this year when the steering committee for Brazil changed the base date for calculating new money contributions from March 1982 to March 1987 since this change just about doubles the amount the Japanese banks will have to contribute. Conversely, the change significantly favors those European and American regional banks that have reduced their exposures through loan sales, etc. While the Japanese can be expected to accept the change and to make their increased contributions, they are now also searching for new approaches, and, in light of their increasing share of the burden feel justified in making suggestions. The ideas recently unveiled, particularly in Toronto, included the following:

1. For the period 1988 - 92 the Japanese Government is willing to extend $50 billion in aid to developing countries particularly for the financing of large projects. This commitment is a fourfold increase from that provided between 1973 - 82.

2. The write-off by the Japanese Government of $5.5 billion in loans made to LLDC's, that is to say the poorest countries made during the 1983-87 period. In this respect Japan is following a French initiative, announced shortly before the Toronto meeting.

3. A $30 billion guarantee facility for three years from 1987 to 1990. This guarantee would be available for transactions done with export-import bank type institutions. The Japanese proposal at Toronto that this facility be chanelled through the IMF appears to have met with some resistance particularly from the U.S.

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Mr. RONA. I think the debt stock problem is a problem of, I think, of not only the borrower but also the lender, because the principal amount rises to a level where the repayment of the amount becomes impossible, raising, therefore, questions about the item on the bank balance sheets as well as raising questions on the national income figures and the balance of trade, balance of payments figures of the borrowing nations. The latter in the case of the borrowing nations then spills over into budgetary problems, taxation problems and difficulty and unproductive political debates.

Senator SARBANES. Well, my time has expired. Senator Bond.

Senator BOND. Thank you, Mr. Chairman, and my thanks to you gentlemen for a very interesting discussion. It is good to see you again, Mr. Wagner, and I thought maybe I would begin by asking you why you thought the size of the Mexican debt transaction was not as large as you had hoped it would be.

Mr. WAGNER. Well, it is difficult to tell, because that's clearly a bank-by-bank judgment as to whether to participate in the transaction or not. We believe one of the principal reasons was that as banks examined the proposition, they also obviously looked very closely at Mexico, and we believe many of the banks said, "Well, why take a 30-percent discount, why not just ride with Mexico? It's not doing that badly. We'll stick with it."

There were other reasons. It was a complex transaction to understand and a new transaction the banks hadn't done before. It's caused a tremendous amount of discussion at the board level in many of these banks, and some of the banks decided, this is the first debt-for-debt swap to be offered and they would pass this one by and see what the next model looks like. And then there were some banks that from an earnings point of view and tax position were not attracted.

So I think there were a variety of reasons. We believe the next model will improve it a bit, and the volume will go up.

IMPLICATIONS OF MEXICAN ELECTIONS

Senator BOND. What do you think the implications of the close election results in Mexico may be for this? Is this telling us something about their economic condition, their willingness to participate that would either encourage or discourage other banks from participating in a subsequent round?

Mr. WAGNER. Well, I don't know. It's difficult to know. I would think some banks might be more concerned about Mexico over time, while others might be encouraged, believing that the direction that Mexico is headed is a healthy one, it is a direction Mexico has to go. So it is difficult to judge. There are great pressures in Mexico to do something about their debt, and I believe they would like to see a program like this work with a larger volume.

Senator BOND. Mr. Nicholson, does the problem with the participation of banks in the Mexican program raise questions for you about the reluctance of free riders, as you call them, to participate in the kind of plan that you set forth? How would you deal with this, if so?

Mr. NICHOLSON. That's a very good question, Senator. I guess I would differ a little bit with Mr. Wagner. I don't think that you would need 100 percent agreement with our proposal in order to implement it in a particular country. After all, countries already have shown that they can unilaterally cut off interest payments. It is nevertheless the case that they are reluctant to do so, if they want to remain members in good standing of the international community. However, if a critical number of creditor banks agree to cut the interest rate, let's say, for 5 years, by 2 percentage points, then I don't think you would have to have 100-percent concurrence. The checks that were mailed out would simply be 2 percentage points lower, and those banks which had opposed it in the beginning would really have no recourse but to sue the country and perhaps never lend to it again.

Now where that critical mass of acceptance lies is a question that can't really be determined ahead of the fact. But I don't think that one needs anything like 100 percent, and clearly, once it has been agreed that an interest reduction is acceptable to a sufficient number of banks, then there cannot be a free rider.

Senator BOND. If it is de facto, they will go along with the ride, because the country will determine that that is going to be the limit of what they pay?

Mr. NICHOLSON. That is correct, and the judgment ultimately is one as to how much damage is done to the future reputation of the country, if it imposes a reduction without sufficient creditor concurrence.

Senator BOND. Mr. Rona, for U.S. banks which may have some problems on debt for equity swaps, what problems do you see with the proposals outlined by Mr. Wagner and Mr. Nicholson?

Mr. RONA. For the U.S. banks or non-United States banks?

Senator BOND. For the U.S. banks.

Mr. RONA. Well, I think that given the situation in which the American banks find themselves and given the basic bank management philosophy and regulatory philosophy that they work under, I think these proposals are perhaps responsive to most of those concerns. My difficulty with these proposals—and while I respect many of the points that were made, there is a fundamental problem that I have with them—is that I don't see them as ultimately bringing about a solution. The fact still remains that these countries are very severely indebted, and the reduction of 2 percent in interest rate is not going to change matters sufficiently.

Senator BOND. Thank you, Mr. Chairman, and thank you, gentlemen. I see my time is up.

Senator SARBANES. Senator Proxmire.

Senator PROXMIRE. Mr. Wagner, you say on page 5 of your testimony that in order to make future debt exchanges like Morgan handled with Mexico, more successful, some sort of guarantee of the debtor countries' interest payments is required. You say further on page 5 that the question becomes, "Who will provide the guarantees to make such a program work?"

How do you answer that? What's your answer? Who should?

WHO GUARANTEES INTEREST PAYMENTS

Mr. WAGNER. Well, the interest guarantee, we are talking about is a rolling guarantee, of 2 to 5 years, which makes a swap more attractive. Now that——

Senator PROXMIRE. Let me just say what I am getting at is, I wondered how you would deal with the charge that this is going to be a taxpayer bailout.

Mr. WAGNER. Yes. I kind of figured you were coming from that direction. [Laughter.]

Our thought is that if interest has a partial guarantee, our swap will be more attractive to the banks, and they will participate in greater volume, which should be attractive for the country.

Now banks are giving up something when they take a discount. In the case of Mexico, banks gave up 30 percent of their principal. They accepted this loss when they exchanged one value for another value. They believe that the value that they are getting is better than they have foregone.

We believe part of the guarantee should be provided by the LDC country so that the early part of the guarantee comes from the LDC country. The guarantee that follows on would have to be from some entity——

Senator PROXMIRE. Let me interrupt. You haven't answered the question as to who provides the guarantee.

Mr. WAGNER. Yes. I'm coming to that.

As I have said, we believe an entity is needed to provide a guarantee, for up to 5 years. We believe it should be the World Bank or the Inter-American Development Bank, and they would provide a guarantee—one that banks can judge and recognize and from an entity where the guarantee can be invoked. We believe to have maximum effect the World Bank should have some sort of funds to back it up. And it doesn't have to be funds per se it can be a backup guarantee from member countries—Japan and Germany, others who would stand ready to fund the guarantee if it were called. It doesn't mean funds are put up, but they would be put up if the guarantee is called.

Senator PROXMIRE. So at least the tax bailout would be internationalized? In other words, it would be——

Mr. WAGNER. Well, I don't see it as a taxpayer bailout; I see it as a sharing of the burden. The banks, by going into this, would be reducing the amount of debt, and the guarantee, if it is invoked, would be a form of international sharing of the burden.

Senator PROXMIRE. Mr. Nicholson, you opened my eyes. I didn't realize that the Nova Scotia bank was such an international operation, and it certainly is. It is very impressive. You say roughly half your business is generated abroad outside of Canada.

How much of that is in the United States?

Mr. NICHOLSON. About 20 percent.

Senator PROXMIRE. How much of it is in Third World countries?

Mr. NICHOLSON. We've got $3.5 billion. It's probably about 8 or 9 percent. A little less than; more like 6.

Senator PROXMIRE. You said 8 or 9 percent?

Mr. NICHOLSON. More like 6 percent of our total earning assets. I'm sorry, sir.

Senator PROXMIRE. When you say half your business, you're talking about half of your deposits or half of your loans?

Mr. NICHOLSON. Well, we raise our deposits in the places where we make our loans, so it's about the same. The balance sheet is balanced.

Senator PROXMIRE. So about 20 percent of your deposits come from the United States, 50 percent from Canada, 9 percent from developing countries, something like that.

Mr. NICHOLSON. We do have some domestic operations in developing countries, but in fairness, we fund our U.S. dollar loans to the Mexicos and the Brazils on the international market—the so-called "Euromarket."

Senator PROXMIRE. Now the Omnibus Trade bill that will soon be signed by the President and become law, has a section requiring the Secretary of the Treasury to initiate international discussions on the creation of an international debt management authority.

Mr. NICHOLSON. Yes.

Senator PROXMIRE. The Secretary would not have to do so, if he determined that the initiation of these discussions would, No. 1, result in a material increase in the discount at which sovereign debt is sold. No. 2, materially increase the probability of default on such debt, or No. 3, materially enhance the likelihood of debt service failure and disruption.

Do you think any of those consequences are likely to follow from the initiation of those discussions?

Mr. NICHOLSON. Senator, I haven't given that perhaps as much thought as I should to give you a definite answer, but offhand, no, I don't think so. In fact, I think on the contrary, that the banking world, as well as many other spheres of interest, are hungry for a more constructive approach to this problem, and anything along those lines would be positive, not negative.

Senator PROXMIRE. Thank you. My time is up, Mr. Chairman.

Senator SARBANES. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

I would like to get at a slightly different question from the excellent ones of my colleagues. To what extent have the conditions underlying the present strategy of restructuring with new lending really fundamentally changed. I mention that because there are indications that the present system that everybody wants to improve upon is bearing up remarkably well without negotiation of new debt facilities. There have been some very remarkable reserving decisions—Citicorp's of last year. All banks are now reserved some 25 percent or higher against LDC loans this year. There have been some significant reductions in exposure to LDC's. The risk-based capital standards adopted for bank capital are creating incentives to reduce problem assets and manage reserves appropriately.

So one question I've got is whether or not there are some or even many major banks that are basically preparing, whether it is by accepting Morgan-Mexico swaps or other means, to abandon LDC lending entirely as an area of international business?

Now Mr. Nicholson, you've got 6 percent of your business tied up there, what are your plans?

ARE SOME BANKS ABANDONING LDC LENDING

Mr. NICHOLSON. Well, sir, we would not like to give up on Latin America and on the middle-income countries. We would like to do a lot more trade finance there. We would like to do project bridging finance. We think that the economic recovery of those countries is crucial not only for our long-term business but for the health of the world trading economy. And we also don't subscribe to the view that the problem has disappeared as a very serious matter for the banking system.

What has happened is that those who are capable of exiting have exited. We have a couple of banks in Canada which participated magnificently in Mr. Wagner's scheme, and they are on their way out, and they have declared that. But there are a number of banks, a large number of banks——

Senator HEINZ. While you are not planning on doing that, is that a trend?

Mr. NICHOLSON. No, I don't think—I think that there is nothing wrong with that. All I am saying is that it's not solving the problems of a number of banks, and it is certainly not solving the problems of the developing countries. We believe that there is an enormous opportunity cost, both economically and in a number of other spheres, which you would be better able to judge than me, that indicates that we've simply got to have a more constructive approach to the LDC problem.

I think we can kill two birds with the same stone. That is really why I am so enthusiastic about doing something.

Senator HEINZ. Mr. Wagner, what do you think? Are banks generally looking for a way out? Leave Morgan out of it.

Mr. WAGNER. I don't mind being included. We are not looking for a way out.

Senator HEINZ. No, I say, just leave you out of the discussion.

Mr. WAGNER. I think there are changes that are taking place, and there always are. There is nothing static about this game. On the positive side, we see many of these countries are much more aware of their problems, and they are taking steps toward making the structural changes that they need to correct their problems. Some countries are making more progress than others.

A second problem, though, is that it is a case-by-case game, and some of these countries are doing well and some aren't, and particularly the smaller countries are going to have a much more difficult time. I think what is happening is that the banks are looking at where they have their money exposed and are saying, why was I ever in some small country? They can understand why they are in Brazil. The potential for long-term business is tremendous there, and they have many customers there, and many of the banks are going to stick with Brazil because of that, or Mexico. But that is not true of some of the smaller countries.

So you find some banks are exiting the smaller countries but not necessarily the larger ones. This is a problem for raising new money, in that many banks are just saying, I don't want to put up new money for small countries with a limited commercial future. I want to find some way around it, some way not to have to put up new money. And that is going to be a problem.

Senator HEINZ. May I interrupt you at that point?

Mr. Rona said earlier that there is still a very serious problem with capital flight. If the banks, by and large, aren't putting up new money and capital flight continues, how can even a relatively better-positioned economy like Brazil or Mexico ever become a good risk?

Mr. WAGNER. Well, we at Morgan have spent a long time on the capital flight issue, and we have written a lot about it. It is a problem, but the answer is good policies. If a country has good policies that are beginning to perform, capital will return. Brazil traditionally has not had a great problem with capital flight. Argentina, Venezuela, and Mexico have. Last year Mexico's problem began to reverse, and they had a reflow. After the election, there have been days where it has bounced back and forth.

I think the answer to the capital flight problem really goes back to, do you have policies that make it attractive to invest in your country? Then the money will stay home and be invested. If you don't, nothing is going to stop it. It is going to go. It is much the same in the United States; there is a capital flight here that has gone out over the last few years.

Senator HEINZ. This is not a question you should answer, but I hope someone asks what I was hoping to get to. To what extent will any new multilateral initiative initiated by the Secretary of the Treasury or anybody else here, as Senator Poxmire started to ask, help or hinder the developments that are taking place.

Maybe you could get around to that in the second round, but please don't answer it now, because it is somebody else's turn.

Senator SARBANES. Well, why don't you take that question under advisement, and when we have completed the round, we can get a contribution on it. Senator Graham.

Senator GRAHAM. Well, my question might give him a basis——

Senator SARBANES. To do so now.

Senator GRAHAM [continuing]. To respond to that.

It seems clear to me, and I believe it is consistent with what you have said, that there is no single solution to this problem. There is a Mexican problem and a solution fitted to its circumstances. There is an Argentine problem and a solution fitted to its circumstances. So it seems to me that one of the roles of the Congress in this process is to attempt to create an atmosphere, a climate which will accommodate that diversity and the flexibility for a United States sovereign response and a United States role of leadership in the international community.

PUBLIC POLICY CONSIDERATIONS BY CONGRESS

With that premise, what do you believe should be the priorities of public policy consideration for the Congress that would contribute to that climate of nation-specific innovation and flexibility in responding to these different economic circumstances?

Mr. WAGNER. Do you want me to answer that?

Senator GRAHAM. Yes.

Mr. WAGNER. Well, Senator Graham, I don't have a definitive answer. I would say flexibility is terribly important, and I think that as I mentioned, this problem is evolving and changing. You

can't always anticipate the direction it is going to go, and it will vary by country. And I believe that it is very useful to have discussions by the Secretary of the Treasury with others as to ways to most effectively cope with the problem. When the Baker initiative came out, I think it was very timely and a good approach to the problem. Times have changed since then, and I think it might be healthy to have a reexamination of what the issues are and what the problems are. But I would say, try to avoid anything that is going to be too restrictive. I mean, when we talk of debt exchanges, there are all kinds of exchanges. There are debt-for-debt exchanges. There are debt-equity swaps. There's a tremendous movement, as Senator Sarbanes said at the beginning, of the shift in the nature of the debt. One of the reasons is that the private sector has figured out ways of paying off, swapping, and using discounts to move out their debt, and that has reduced the debt of these countries.

So I would say anything that provides flexibility, and in some cases, there is going to be a need for some backup, some stimulus to encourage some of these flexible programs from the World Bank or other institutions. I think any support of that would be helpful. Both the program that Mr. Nicholson was talking about and the one I am talking about, new evolutions of this sort could benefit by some support from the World Bank or others in giving some backup, some guarantees. These should be done in a way that is leveraged, so that the international institution gets a real return out of anything it puts in, but it should be considered and thought about and could be a way to help further open up solutions to the problem.

Mr. NICHOLSON. Senator, if I could just echo in on that. To borrow a phrase, I think what we see evolving here is a "menu of strategies" and not simply a "menu of options". The menu of options is too narrow. The problem—it is not a problem, but the shortcoming, I suppose—of the exchange options is that they tend to be too marginal. There is still a system problem. There is a system problem in the countries, and there is a system problem in the banks. Of course, there is nothing in what I have suggested which is inconsistent with exchanges or with new money coming from appropriate sources or with a debt discounting facility that Mr. Robinson spoke about.

Personally, I would see our proposal applying to the big countries, those countries which are potentially viable, but which need a period of workout. There are obviously some countries which are so overleveraged, whose economies are so weak, that probably there should be some principal writedown. It is inevitable. But it is not inevitable in the case of Mexico. So I think you could apply our proposal in the specific case of Mexico to establish a prototype. Mexico is a good example, because they have some foreign reserves that they could apply to the interest insurance pool, in addition to relief which the banks could offer, and that removes the government contingent liability even further.

But I think you'd need to try that out on one country, where you had some reasonable prospect of success. Then learn from the negotiation what the really tough issues are, and hope you could generalize it to the other five or six.

That would be my priority.

Senator GRAHAM. Mr. Rona.

Mr. RONA. Well, I think the first and foremost issue would be the narrowest issue, would be safety and soundness of the American banking system. That I think should receive attention over and above anything else. The system as a whole.

The second issue is the extent, if any, to which the United States has a continuing interest in various parts of the less developed world. Does the United States have any kind of a political or strategic interest in Latin America? That is certainly an appropriate question for the Congress to decide and then to take the steps that are commensurate with what it deems to be the appropriate degree of interest.

I am personally somewhat skeptical about the mixture of public-private kinds of solutions, such as World Bank guarantees, which World Bank then, in turn, is supported by government support, and so on and so forth. I think the banks should be left to do their loans and suffer the consequences, such as they may be, and that should be a long-term proposition.

To the extent that governments find it appropriate, in light of policy considerations they themselves deem important, as the French did in Africa, they should contribute to the development of these countries. In the case of the French, it was the forgiveness of debt to the French Government. That's all well, but I think those two issues should be kept somewhat separate. Some would say the political issues associated with national interests in developing countries are quite different from the issues associated with the kind of lending that commercial banks should be engaged in. So I don't think the two things ought to be together.

Senator SARBANES. Senator Sanford.

Senator SANFORD. If I could follow up on the last comment, in the case of South America and Central America, certainly there are considerable policy reasons for this country to worry about the stability of those governments. I know Mr. Nicholson, for example, has given a lot of attention to debt relief in Central America. We may be talking about the kind of action that is really not effective if, indeed, our goal is to help create a stable society.

I am concerned about the need for some urgency in providing debt relief. How long do you think we can wait to promote debt reduction, and to get out of this defective posture and onto a more positive development strategy for these struggling countries? Specifically, I would like your comments on the timetable in Central America.

CONCERN ABOUT STABILITY

Mr. NICHOLSON. Well, Senator, if I might lead off on that. It is obvious that no one can give you a number of days, weeks or months. It isn't that kind of problem. It could, of course, become critical if we had a macroeconomic crisis in the world. I am talking about another spike of interest rates or a recession, in which case all of the LDC's are simultaneously in trouble and the banking system is in big trouble. But when you look to individual regions and when you look to the continuation of the situation we have, it is not so much how long can it go till it breaks, but rather the op-

portunity costs in letting it go on one more day. I mean, there is a cost which is steadily accumulating. At which point it becomes critical, no one can ever know, but I think damage is done already in many countries that is not going to be easily repaired.

That is all I can say. It is unfortunate in political life—and it doesn't matter whether it is the United States or anywhere else—we often have to have a very tangible front-page crisis before we can really spur ourselves to action. I think it would be unfortunate if we had to wait that long. In fact, a number of the proposals that I have been hearing here this morning are precisely designed to avoid that problem. But how you muster the political will to act more quickly, I don't know.

Senator SANFORD. I am concerned that while we talk about how we can handle these problems without absolutely bankrupting the Nation at the moment, these fragile democracies that have promised roads and facilities and education and those things that would build a strong democratic nation are forced to put these development efforts on the back burner, if they are on the stove at all, because they are just struggling to keep their heads above water and make their debt payments.

Mr. NICHOLSON. Well, I think that is what creates the rationale for public involvement here, and unlike my colleague, Mr. Rona, I don't think it would do all that much damage to the commercial banking system if there were a contingent involvement by governments for their own policy reasons. In fact, I think it would evoke a much more substantial contribution from the banks, because the security they would gain would be a very tangible value.

Senator SANFORD. I think Mr. Wagner was seeming to say that the government had a role, but he might want to expand on that. Our role may be not just a role to bail out or put their credit in better shape but could be a broader role that justifies taxpayers' money, not for a bailout, but maybe for a backup.

Mr. WAGNER. Well, if I can make two comments. One was on your question about the countries. As I indicated earlier, our greatest concern is not with the larger ones. We believe they have the potential to bounce back and to work out of their problems. It won't be easy. There will be a few more years of difficulty, but we believe they can work through it.

We are much more concerned by the smaller countries such as the Central American countries. They have a lot of debt, limited resources that they can build on, and not much incentive for support from outside. A push from the World Bank or the Inter-American Development Bank is needed to get these countries moving. I don't think many commercial banks are prepared to stick with these countries, because they don't see a long-term strategic reason to be involved. They are questioning why they were there in the first place.

So I believe we have to divide the problem into the countries that have the resources to develop, and work their way out of the problem. Many of these smaller countries don't have the resources and have too much debt. I believe that is where the real crunch is going to come.

I believe the second concern is what the U.S. Government should be doing. I believe it should encourage the World Bank to play as

active a role as possible, not just in lending money, although they should do that too, but creating new ideas, new incentives, using their guarantee authority where it is appropriate to add leverage, to encourage new ways of addressing the debt problem. I think the World Bank looks upon itself as a development institution, which it is, and it does a very good job at that, but a big part of development in these countries is going to be solving the debt problem. If they can't solve that, it is going to hold back their development for a long time.

The World Bank should really devote much more attention to solving this debt problem.

Senator SANFORD. We don't have time to get into it now, but you said the banks were wondering how they got into it in the first place. I wonder that too. We've got to come back to that, Mr. Chairman.

Senator SARBANES. We have another panel waiting, but I think we are getting a great deal of help from this panel, and I want to just put a few more questions to you, maybe begin at least part of a second round.

Yesterday, Rodrigo Botero—on Tuesday, the former Finance Minister of Colombia—said in his statement, and I quote him:

> A remarkable aspect of the debt crisis so far is the commitment of democratic governments in the region to remain in the existing international framework and fulfill external obligations at a high political cost.

And I must say to you, I have been struck by that, and I wonder what our perception of it is. One answer is, well, they have to do it because if they don't, they are going to lose the trade credits, and they will just be dealt out of the international economic system, and therefore, there is a real stick here at work.

Another perception is, they are really trying the best they can to try to meet their problem and work within the system, try to get the system ameliorated so much. There is a lead story in the papers today:

> Argentines Ask Shultz for Flexibility on Debt.

I think this is what the Secretary has been met with right, and,

> Buenos Aires has heard pleas from top officials and politicians for more flexibility. Alfonze Zine told him it was necessary to find something other than conventional procedures to deal with the cost of servicing Argentina's $55 billion debt.

What is your perception as to why—first of all, do you agree that in a sense it has been remarkable that these democratic governments have been willing to stay with and try to work within the existing framework.

What do you attribute that to? Mr. Rona?

DEMOCRATIC GOVERNMENTS ARE STAYING WITHIN INTERNATIONAL FRAMEWORK

Mr. RONA. I would attribute it to two factors. First of all, I agree with the statement. I think it is remarkable, and it is somewhat in contrast with past experience, historically.

The first one is that the democratic governments in some very important countries have a strong desire to maintain strong relationships and good relationships with western democracies. They

see the future of their countries as being largely contingent on their ability to bring that about. So there is a clear political perception of an interest in maintaining good relations with industrialized deomocracies.

The second one is that the approaches to autarky that may have been available in past debt crises such as the Argentine crisis in the thirties and the Colombian crisis in even 1955 are no longer available. The few experiments with that approach that we have seen since 1980, such as they were, have not been successful, so that the South American and other LDC economies are much more integrated with the industrialized economies than they were in the past.

Those are the two principal ones. There are some narrower ones. You must bear in mind that moneys in the form of aid, in the form of equity investments are starting to flow into at least some of these countries. The Japanese have been very active, particularly in the Pacific Basin, in helping some of these countries, have made some significant contributions. Some of the Europeans have been active in Africa, and the Japanese are now becoming increasingly active in Latin America.

So it is not clear that from the point of view of these democracies in Latin America a default would, in fact, serve their purposes any more.

Mr. NICHOLSON. Mr. Chairman——

Senator SARBANES. If anyone wants to add to that.

Mr. NICHOLSON [continuing]. If I could just echo my complete agreement with what Mr. Rona has said and say that I believe the significance is that there isn't nearly the moral hazard in concessional approaches that is often alleged. By "moral hazard", I mean the view that if you give these debtors an inch they will take a mile, and they will immediately backslide. I think the reason why they have persevered, notwithstanding these terrible difficulties, is because they are genuinely committed. They believe in this. They are not looking for a way to slide back, and if you permit them some relief that will help them move forward, the last thing I would expect to see them do is to slide back. I think all the evidence we have seen over the last 3 or 4 years really mitigates the strength of this moral hazard argument which is often trotted out in opposition to any kind of relief.

Senator SARBANES. Let me make an observation to you and then put a question that follows on it.

As an American policymaker concerned about the U.S. leadership role in the world, I am disturbed by what took place at the Toronto summit. In this regard, I think we face a major international economic problem. France came with an initiative, limited, but nevertheless important in that area, but Japan came with a broader initiative, perhaps not fully worked out but put on the table. Both therefore, appear to be concerned and are trying to be responsive in one way or another to these problems of the developing world. The United States appears as the recalcitrant actor in this situation. It seems to me it raises the danger of undercutting our economic and political relationships with a very significant part of the world, and I wonder whether you think that concern is justified.

Mr. RONA. I think it is fully justified. I thnk the Toronto episode was unfortunate, and I think that the response we gave to these initiatives was not particularly good. Moreover, since Toronto took place, there has developed a hiatus. Effectively, the Japanese proposal, and it is very much in the Japanese style, may appear to us as having been somewhat not defined, but the Japanese tend to develop proposals that give empty spaces for other people to make their contribution, and it is this process that will ultimately evolve into the solution, rather than a hard-edged proposal that results, you know, in a confrontation and negotiation type of an approach.

So there is more to that proposal in that sense, and I think it is a very important and helpful proposal, and I think it is unfortunate that it was not taken up with the degree of interest and seriousnes that it deserved, particularly at a time when the Japanese are showing increasing signs of willingness to expend considerable amounts in foreign aid to the less developed world, and we, of course, are having difficulties in doing that. I think it is a fruitful and important time to encourage that trend on their part. I think these matters should be aggressively pursued. The same with Europeans, but particularly the Japanese proposal.

Senator SARBANES. Mr. Wagner.

Mr. WAGNER. I would just like to say that my impression is that the administration's position at the Toronto meeting was that the best program to follow has been the Baker initiative and that they should stick with that and continue to follow it.

I think there are reasons for that. I believe the Treasury is concerned that these new initiatives, whether it is one I have suggested or Bank of Nova Scotia's, might turn banks away from putting up new money for Baker initiative types of programs. I also believe they are concerned that too many solutions splinter the control. But as I said earlier, this is an ongoing problem that evolves. And I think there has been some evolution since the Baker initiative program was worked out, and I believe it would be valuable to reconsider where we are and where we are going. This is not a time, given the political events that are taking place in this country, to address the problem right now, but certainly, the idea of having these hearings, and I would hope from this would flow further discussion by appropriate administration officials as to where the United States does go and what role they will play, and is the Baker initiative the best way to go or not and can it be improved upon.

Senator SARBANES. Well, these hearings, plus what we were able to get in the trade bill may begin to lay the base in the coming year to have a proper examination of what our alternatives may be in the sense of bringing parties together and examining it in some depth, but I do agree with you. I think when Baker made the initiative at that time, it was a constructive move compared with the policy that had preceded it. It has not produced the results that it was asserted it would produce, and it doesn't appear that it is likely to do so. The problem remains, and it seems to me we have to come at it with a new or more developed approach.

Mr. NICHOLSON. Mr. Chairman, if I could just chime in with a Canadian perspective on your question. There is no question in my mind, having talked to the Canadian Government at the ministeri-

al and the official level for 2 years about the debt strategy, that the leadership of the United States is critical to the role that Canada is prepared to play. And as long as the administration was unprepared to move, Canada was unprepared to move.

One might argue that that is not the way a sovereign country ought to behave, but that is the reality.

So an initiative by the administration would have a lot of leverage is the point I wanted to make.

Senator SARBANES. Senator Graham.

Senator GRAHAM. Well, you didn't ask me the question that you asked the panelist, but if I could take the opportunity to respond. I believe that the statements and questions that were asked by Senator Heinz and the observation just made by Senator Sarbanes, sort of define the issue. Senator Heinz made the case in his questions and comments that this report card by which the Baker plan should be evaluated is essentially the effect that it has had on U.S. commercial banks and then proceeded to make the case that the balance sheets of banks are better now than they were when Secretary Baker gave his speech in Korea.

Senator Sarbanes' comments inferred that the report card had some additional items that needed to be checked off. What has been the effect of this on U.S. political influence in the countries affected? What has been the effect of this upon the political stability within the region? What has been the effect on economic reform and economic growth within the region? What has been the effect on U.S. trade within the region?

My observation would be on that broader report card, and I concur that that is the appropriate report card to be issuing or that the grades are not satisfactory. So I think that we have in this morning's discussion framed the basis of what really needs to be a national debate on how we look at our responsibilities and our long-term interest as it relates to our economic and political responsibilities and influence in a major part of the world and how do we construct public policy that will create an environment and atmosphere for both public and private responses that will deal with a wider range of national concerns.

Having said, that, I would be interested in the question of what do you think we can learn from this experience? Mr. Rona gave us a 150-year snapshot of economic relationships between the United States and Latin America.

Specifically, narrowing that down to just the last 10 percent, the last 15 years, what have we learned that we ought to be applying to our future? I entered into the record a couple of days ago an article from the current "Economist," which talked about Eastern Europe and said we were repeating some of the same practices there and predicting that Eastern Europe would be the Latin America of the 1990's.

What do you think we ought to be learning from this experience and how should we be applying it? And the "we" in that are the private sector, commercial banks, and governments, both individually, specifically, the United States, and in terms of our international role.

A LEARNING EXPERIENCE

Mr. RONA. If I may just make a comment on Senator Heinz' point, which I didn't have a chance to make at the time I am not sure that even within that narrow scope that you described, the market is as favorable as it might at first seem. The Baker plan has had the result, of permitting the banks or putting the banks in a position where the markets lost confidence in their shares, with the effect that major American banks have had a price-to-earnings ratio that makes the cost of capital to then extraordinarily high.

Now you are talking about maybe 6½, 7 times earnings as an average for the larger American banks compared to 10 times that for the Japanese banks and compared to about 4 times, 4½ times to the major European banks.

Now the point becomes important, because we are looking at the new capital requirements under the Basle accord that are going into effect, and while it may be that many banks around the world will have to raise capital, it is well worth to ponder the meaning of that cost differential and what it will do to the relative competitive positions of banks from these different countries.

So I think that if the Japanese banks will be able to satisfy these requirements at a tenth of the cost to what the American banks will need in order to satisfy those new requirements, that will undoubtedly have not insignificant competitive consequences. But I think that the two issues, the Baker plan, Latin America loan handling, and this matter are not unconnected.

Now, I think the No. 1 lesson, very quickly, is that commercial banks are not suitable vehicles for sovereign risk lending for a whole host of reasons, but they have not proven to be able to get into the crisis well and get out of the crisis well and to let things go on. Here we are, 6 years into the situation, and we don't have a solution.

Second, that some of the developing countries made a major mistake, when in a nationalist mood they decided not to permit equity ownership or majority equity ownership in many of these countries after World War II. This has put an enormous pressure on debt finance in their development. As you know, most of these countries proscribe foreign ownership of local companies, majority control, a very negative result, because in an equity situation, when a foreigner invests in the equity of the country, he makes a bet that that economy is going to perform. The debt situation, of course, has a contractual obligation of periodic payment of interest and repayment of principal, independent of how well the economy or that enterprise may come out. Not a good idea in essentially vulnerable weak economies' development situation. Development situations require substantial amounts of equity capital, and I think that is the second lesson that conditions for equity type investments, for risk-type investments rather than debt finance, have to be enhanced.

These are the two points I would make.

Mr. NICHOLSON. Senator Graham?

Senator SARBANES. Yes, Mr. Nicholson, you want to add to that?

Mr. NICHOLSON. Yes, a little. I agree with everything that Mr. Rona has said. I think to try to put it in its broadest context, the most profound lesson we have learned is something about the ap-

propriate role of banking systems. If you look back at the origin of this problem, there was a deliberate and encouraged use of the banking system by both the lenders themselves, as well as by authorities.

The banking system was used to recycle a massive global imbalance—in this case the accumulation of petrodollars. The free market was allowed to take over, through the medium of the banking system, a macroeconomic role of global proportions that perhaps in the past only governments could have undertaken or conceivably the private bond markets.

But it was not the right role for the banking system, and I think that is the fundamental lesson that has been learned. It is not all that easy, nevertheless, when you have a private market, which inevitably is blind and driven by competition, to necessarily avoid making the same mistake again. I think we have to understand very clearly as regulators, as people responsible for the safety and soundness of the system, that to rely on it, to deal with global macroeconomic recycling problems is a very, very dangerous undertaking. These are not the kinds of credit judgments that bankers are capable of making and that banking laws, in respect of security and what have you, are capable of enforcing.

Senator SARBANES. Senator Sanford.

Senator SANFORD. Well, Mr. Chairman, I have got a whole fistful of questions to ask, but I also have got to go make a speech about something called "sustainable development" at 12 o'clock. I would like to bring on the other panel.

Senator SARBANES. We will do that now.

Senator SANFORD. I would like to thank this panel for the information they have brought us. It is outstanding.

Senator SARBANES. I would just like to make this comment in closing. I think one of the challenges that we are trying to address here, because I think, Mr. Rona, we have gone too far in terms of separating out the banks' role and their exposure from the broader economic and political question. You may be right that if you get back to the starting line, you would separate that out, and the banks would play one role, and if you went beyond that role, it would be done differently, either through the World Bank or directly, but at the moment, it has gone beyond, and we have to figure some way of working out of that.

You know, the notion that if the banks take a hit of 30 or 40 or 50 percent on their loans, but then to assert that somehow they're being bailed out as part of making that process work by bringing in guarantees or even an international facility that assumes the burdens that is government-backed in one way or another, it seems to me it is not accurately preceiving the situation, because, in effect, you are taking the governments and their taxpayers out of a situation where they may have to bear 100 percent of the burden and moving them into a situation where they may only have to bear 60 percent of the burden, and where it is much less likely that they will have to bear the burden.

So I think it is partisan educational process that is involved here, and obviously a political will.

But you have been an extraordinarily helpful panel.

At the end of Tuesday's testimony, members commented on the quality of the presentations we had had then, and this panel has certainly measured up to that standard, and we are most appreciative to you.

I think I would be remiss if I didn't want to add one final word, and that is, we are trying to look ahead, we are talking about different concepts and trying to address this situation, but I think we ought to make some recognition of Mr. Wagner, of your efforts, and the efforts of Morgan Guaranty to deal in a innovative and constructive way with this problem, as reflected in the Mexican situation. Now maybe it didn't prove out as much as people had hoped, maybe there are other approaches that we need to take, need to go beyond it, but I think I ought to at least pay some respect to you and the Morgan Guaranty for your efforts in terms of trying to be creative in addressing this situation.

We thank all of the panel for their testimony.

Mr. WAGNER. Well, thank you very much, Senator. My only comment would be, we sure stirred up a lot of people! [Laughter.]

Senator SARBANES. Thank you very much.

If we could bring the next panel on, we will move right along.

Our second panel this morning consists of Albert Fishlow, the chairman, Department of Economics at University of California at Berkeley, Rudiger Dornbusch, professor of economics at MIT, and Shafiqul Islam, who is a senior fellow at the Council on Foreign Relations in New York.

Mr. Fishlow, why don't we start with you. We will move right across the panel, and the subcommittee is happy to hear from you.

STATEMENT OF ALBERT FISHLOW, CHAIRMAN, DEPARTMENT OF ECONOMICS, UNIVERSITY OF CALIFORNIA AT BERKELEY, BERKELEY, CA

Mr. FISHLOW. In view of the lateness of the hour, Mr. Chairman, I will try to summarize my remarks, so that we can have more time for panel discussion.

Senator SARBANES. The full remarks will be included in the record in every instance.

Mr. FISHLOW. In the first instance, I should say that my oral remarks as well as my testiomony refer primarily to the heavily indebted middle-income countries. As we all know, there is another debt problem that afflicts the low-income countries that principally depend upon official lending. As much as 85 percent of their total debt is official, as for the countries in Africa. For them, different kinds of solutions are necessary. They are countries that are burdened by a very large resource outflow, paying out more to the official institutions than they are receiving. Efforts are under way, both for debt relief, as well as for reversing that situation.

But it is also clear that in terms of the financial system, as well as a much of U.S. foriegn policy interest, the middle-income countries are of prime concern.

FAILURE OF THE BAKER PLAN

I am pleased this morning to join what seems to be unanimity concerning the inability of the Baker plan to resolve the problem.

That approach, which focused upon increasing debt as a mechanism for trying to stimulate recovery in the indebted countries, failed for a variety of reasons. One, of course, was that the private banks, in the last analysis, were unwilling to support it. They did not make available the necessary resources. In the second instance, under those circumstances, countries were not able to adjust adequately, and so the record of performance over the last 3 years looks just about as bad as it was between 1982 and 1985.

And I also should mention in passing that trying to put together programs of solution of debt by more debt doesn't ever seem to work. If one goes back to the 1890's or to the 1930's or to the Baker plan in the 1980's, the results seems very similar. And the reason they are similar is that it is very hard to get people to put up a lot more money in circumstances that look dubious. It takes a lot more money in order to turn the situation around.

That said, it may be useful here to move on and to consider more explicitly the question of a facility that you and others in the Congress, have sponsored. By looking at some of the arguments that surround it, we can sharpen the debate about the nature of the problem and even more importantly the characteristics of a solution.

With respect to a facility, I should point out at the outset that it is not inconsistent with improving cash flow up front. A facility that plans on a case-by-case basis the adjustment programs in individual countries is perfectly capable of organizing immediate interest-rate relief as well as simple reduction of principal. Each corresponds to a reduction in the present value of the debt. One can use the facility in a way that tailors the debt relief specifically to the needs of individual countries within a general context of using the market discount as a way of obtaining real resources.

That said, let me take up six arguments that are frequently addressed against such a facility.

The first is that the present situation is, after all, reasonably good. I think here the record is quite clear, whether it be the economic results, the rate of growth of the developing countries, or the continuing efforts of banks themselves to find other solutions or the political message that is being received loud and clear from within the debtor countries. The situation is not all right, and it is very evident that it is only a matter of time, and I would say, not a long time, before there is another minicrisis that has to be dealt with.

In the second instance, as you earlier alluded, to think of a facility or some other debt reduction arrangement as a bailout of the banks is something of a perversion. The present circumstances are really very much more of a bailout. What we are seeing is a large increase in official lending that is being used to pay the interest on past commercial bank lending. To make the banks forego some of this income and bear some of the burden is clearly consistent with some solution to the problem.

A third argument, which is, of course, the other side of that coin, is that a solution would make the banks pay too high a price when their balance sheet position was fragile.

The record suggests that the stock market understands the present situation quite well. As was earlier suggested, we have

seen that those banks holding high quantities of developing country debt are penalized in terms of market evaluation. We have seen that over the last year, the banks have worked vigorously in order to reduce their exposure precisely as one way of improving their access to the new capital that they will need.

Any practical scheme recognizes the vulnerability of the banking institutions by allowing gradual work-offs. I do not believe that this issue is a very serious problem.

The fourth argument is that such an arrangement for debt reduction rewards poor performance and, indeed, possibly gives some incentive for poor country policies in order to reduce the value of their debt in the secondary market.

Here, as was earlier suggested in this hearing, I think the interesting point is that countries continue to service their debt well beyond what would have been predictable on the basis of the large outflow of resources they have experienced. The likelihood that countries will have paid such a high price in foregone economic growth as they have, indeed, done, in anticipation of being bailed out of their debt, is farfetched.

In any event, the key question for public policy is the future, not the past. The real issue is what kind of policy now will create the right kinds of incentives for better performance within the developing countries. Debt reduction can provide needed additional degrees of freedom for policy within the countries to enable them continuously to service their remaining debt over its lifetime and to return to sustained economic growth. That translates into increased imports and thereby stimulation for the world economy.

A fifth argument that has been advanced is that reduced debt service won't help performance and that the countries will only hurt themselves by reducing their creditworthiness.

On this score, it is possible through a very simple calculation to suggest orders of magnitude of benefits. If there had been simply a one-third reduction in the interest that the 15 IMF highly indebted countries were paying, the increase in the rate of growth on a per capita basis over the last 3 years would have been on average about .2 percent a year. That comes out to about half the growth of those countries, in fact, experienced over that interval. And such a calculation does not take into account any of the obvious externalities associated with better policy, larger amounts of domestic saving, improved trade policies and the like, that would be in place in the context of a well-organized adjustment program.

With respect to the creditworthiness argument, I want to note that the evidence does not suggest that countries that find themselves unable to pay their debt are subsequently penalized where the market recognizes that it is an inability to pay rather than unwillingness to pay. Whether the circumstance be the case of the interwar debt of Latin America or again going back to the 19th century, memories are able to differentiate the circumstances of reduced debt service. When arrangements have been sponsored in a public fashion, that problem is eliminated completely.

Finally, I want to come to the hardest problem that is associated with any arrangement, whether a facility or otherwise, and that is the question of public resources. We all know how difficult it is now to find resources for domestic purposes, let alone for foreign

purposes. Yet in the last analysis, to walk away from the debt problem for that reason is really to evade our responsibility. It will only be in the context of a minimal public contribution shared with other countries that we will be in a position to mobilize much more private market resources as we try to move to solve the problem.

Thank you.

[The complete prepared statement of Albert Fishlow follows:]

Statement of Albert Fishlow

Subcommittee on International Finance and Monetary Policy

U.S. Senate Committee on Banking, Housing and Urban Affairs

August 4, 1988

We are close to marking the six-th anniversary of that dramatic August Friday the Thirteenth when Mexican inability to pay signalled the beginning of the debt crisis. It took three years, until the Bank-Fund meetings in 1985, for Secretary Baker to recognize the need for more aggressive public intervention to assist debtor economic recovery and thereby their capacity to service debt. That strategy was based upon provision of more debt, private and official, combined with debtor country reform. Now, even as augmented by the April 1987 "menu approach" comprehending new options, the Baker Plan can no longer serve as the basis of United States policy. It is time to recognize that more aggressive debt reduction is needed to move resolution of the debt problem forward.

The Baker Plan did not work for several reasons. Private banks were unwilling to make large new commitments of funds to already overindebted countries. Debtor countries, struggling with a continuing debt burden, were unable significantly to improve their economic performance: large outflows of real resources penalized adjustment. Industrialized countries, in turn, were unwilling to underwrite a program of larger finance that would have been necessary, flows of resources to compensate for the drain. High real interest rates and slow growth of world

trade, with deterioration of terms of trade, complete the story. More generally, whether in the 1890's or the 1930's or the 1980's, solving a debt problem by more debt doesn't work well. It is difficult to obtain secure, large and continuing supplies of credit when countries are already in trouble.

The recent record is clear. From 1985 to 1987, the 15 heavily indebted countries have received -$15.9 billion in net external borrowing from private sources, compensated by +$26.5 billion from official creditors. In these circumstances, 1987 imports in nominal terms barely exceeded their 1987 levels. Transfers abroad of interest payments of 4-5 percent of GDP have contributed to declines in investment rates of equal magnitude since the early 1980's. Interest payments that can represent as much as a quarter and more of government expenditures contribute to fiscal deficits. The story is one of high domestic real interest rates, inflation and slow growth. Per capita GDP has increased cumulatively by 1.4 percent since 1984, and income, adjusting for deteriorating terms of trade, has declined. For some countries, more than a decade has been lost.

In the shadow of this inadequate economic performance, secondary markets have revalued the probability of repayment downward through discounts of 50 percent and more. Banks dramatically increased their loan loss provisions in May 1987 and have successfully set about reducing their exposure over the last year. Countries have found it more difficult to sustain debt service, and interruptions and renegotiations have become more frequent.

This scenario will not much improve with marginal changes.

Despite the publicity, debt-equity swaps remain small and subject to the criticism of ignoring the internal transfer problem: where do the real domestic resources come from to retire the external debt? Exit bonds are not particularly satisfactory instruments because they provide no special guarantee. And the market correctly discounted the recent Mexican bond offer because only the principal, and not the interest, was secured. More conventional buybacks require reserves that few debtors have available. And there is no relationship between all such individual transactions and the continuing structural adjustment that debtor countries must pursue to return to long term development paths.

The Congress has been more sensitive to the need for additional action than the Executive. Senator Bradley has proposed reduction of interest payments and outstanding principal for three years. Senator Sarbanes and others have focused on a debt facility to take advantage of the market discount and pass it along to countries. More recently, James Robinson of American Express has come forth with still another variant of a facility. Interest relief and debt purchase are not mutually exclusive. A facility could structure its debt relief up front through reduced initial service rather than proportionally along its life. The choice depends upon an assessment of the most efficient trajectory of additional resource supply to induce policy reforms and sustained economic recovery.

The inherent purpose of a facility is to substitute a lower yield, more secure instrument that banks would find preferable to

the high yield, uncertain developing country loans they presently hold. Through such intermediation, one reduces the real cost of debt service, a saving that can be passed along to the countries. That is of course the same philosphy behind the establishment of the World Bank in the first place, enabling countries to borrow at much lower rates than they individually could, if at all.

The facility would need a paid-in capital, as well as its diversified and reduced, and hence more secure, debt service from developing countries to back its obligations. It would also need to assure continuing performance by debtor countries through design and monitoring of medium-term adjustment programs to restore past trends of economic development. This latter package of responsibilities could be delegated to the World Bank, as some proposals suggest. My own preference, since debt reduction should be seen in the context of continuing public long term lending, is to add such a special fund onto the Bank itself.

Such plans for debt reduction have been criticized from several perspectives. I focus here on briefly reviewing those arguments as a way of clarifying the underlying issues.

First, it is argued that progress is being made and that the status quo is adequate. It is necessary only to be patient. Such an optimistic view is contradicted by the behavior of the banks themselves, assessments in secondary markets, increased debt-export and debt-product ratios, continuing poor economic performance in debtor countries and the radicalization of their electorates. The short-term debt crisis has eased in these six years, but only to be replaced by a long-term debt problem.

Second, Secretary Baker is fond of saying that such

arrangements are bailouts of the banks, relieving them of putting up more money. In reality, as noted above, official lending has provided a margin for continuing debt service to the banks, eroding meanwhile the quality of public loans. Banks should be in the business of providing trade credits, moreover, not balance of payments finance. The objective of public policy should be to rectify the mistake of the 1970's when recycling was left to the banks, not to perpetuate it at the expense of developing country growth.

Third, and inconsistently with the above argument, it is suggested that banks, especially in the United States, would be very adversely affected by selling assets at a loss. All proposals recognize the need to phase in the inevitable increases in capital that would be required by using loan loss provisions against actual write-downs. And security markets already recognize the make believe quality of current accounting by penalizing banks with large developing country debt. It will be easier to raise capital when banks are not burdened as they currently are. While it was reasonable to insulate banks from market forces at the beginning of the crisis in 1982, it is not appropriate now to give priority to full debt service.

Fourth, it is argued that debt reduction rewards poor performance by offering relief to the countries that have done worst. Some go beyond to suggest that countries would have an incentive to reduce the price of their debt, and hence augment their relief, by even poorer policies. These are valid but not essential points.

Countries have done better in sustaining their payments over a protracted period of negative real resource transfers than might have been predicted; there is more a bias in favor of national honor than a conscious calculation of the benefits of default, let alone possible debt reduction. The issue, moreover, is the future, not the past. How can one now best create incentives for better policy performance and maximum repayment. Countries that have paid because they could will not now stop. And it is a simple matter to avoid the moral hazard problem. Market prices need not, and should not, uniquely determine the schedule of future service payments. That is the role of a full adjustment package.

Fifth, some suggest that reduced debt service will not help debtor countries much, and possibly even hurt. The additional resources will not make such a difference, pressure will be taken off domestic policy and future creditworthiness will suffer more than under a program of continuing payment.

Calculations of the impact of reduced debt service are admittedly uncertain. What we do see are the negative effects of the existing debt overhang. Even a simple approximation provides some notion of a minimum impact. Assume a reduction of interest payments of only about a third on non-official debt of the 15 heavily indebted countries; then a 20 percent return on the investment of this $9 billion would yield an incremental per capita product growth of about .2 percent annually. That is almost a fifty percent increase over what has actually been achieved since 1984. And this is without adding in additional indirect benefits from embedding such a reduction in a comprehen-

sive economic package that would be required as a counterpart to debt service relief. Domestic policy will be more consistent and continuous under the carrot of adequate finance than conditioned by minimum inflows of capital and short-term monitoring.

The rather less satisfactory results achieved during unilateral moratoria are not counter-evidence. Interest not paid cannot be applied effectively in an uncertain business environment that accompanies a moratorium. The case of Peru, for example, confirms, rather, the need for a cooperative framework for dealing with the debt problem.

The costs in future creditworthiness of debt reduction are not at all obvious. Historical evidence does not confirm a penalty to Latin American defaulters of the 1930's in the post-war period, for example. And earlier experience equally suggests that in prosperous times, all governments could raise money; and in slumps, none, even the virtuous. And that was in the context of a continuing and well defined capital market open to peripheral countries.

What we face now is a discontinuity. The arrangements of the 1970's were temporary; commercial banks are not development banks. They are eager to get out and will. Future flows to developing countries will be the province of official sources, direct investment and new private providers. Future economic performance and prospects, not the adverse experience of past commercial bank indebtedness, will determine access. The issue is whether some form of debt service reduction can contribute to a more certain economic recovery.

Sixth, a powerful argument against any type of intermediary, whether independent or related to an existing institution, is that it requires public capital. Resources are certainly scarce. Domestic constituencies in the industrialized countries, even when favorably disposed, do not single out developing country debt reduction as a priority. The United States contribution to the general capital increase of the World Bank has still to be made. The Bradley approach seeks to circumvent the problem by lodging the cost of debt service reduction directly with the banks, but raises other issues of mandating such behavior.

Any facility would leverage the required paid-in capital, as does the World Bank, by borrowing in capital markets. That reduces actual payments required to perhaps 10 percent. Nor does all developing country debt have to be purchased. An initial contribution of $10 billion could well underwrite a facility that was of a magnitude of $200 billion in loans at face value (assuming an average 50 percent discount).

The real issue is not whether United States and other industrialized country taxpayers will pay, but rather how they will do so. Tax losses will result on still larger write-offs that banks may have to take if the problem continues to be unresolved; note the continuing deterioration of prices in secondary markets. In the end, more official loans will be necessary to shore up a shaky situation, a flow that will have less positive impact than equivalent debt reduction.

Cost effectiveness of the resources expended, and not only amounts, count. In this regard, like the World Bank itself, one can anticipate profitable performance for a facility that begins

Senator SARBANES. Thank you, Mr. Fishlow.
Mr. Dornbusch.

STATEMENT OF RUDIGER DORNBUSCH, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Mr. DORNBUSCH. Thank you, Mr. Chairman.

Like Mr. Fishlow, I want to be brief. I will not comment on what the Baker plan may have done for us, but want to move directly to what it no longer does.

First, the voluntary lending. It is certainly clear today that banks want to get out of Latin America, the faster, the sooner, the better. There is no prospect of voluntary lending and, therefore, that cannot be a consideration in any solutions that are being thought about today.

Second, Latin America is deteriorating rapidly. Brazil and Argentina are facing their second hyperinflation in 3 years. That is not a situation where one can show genuine results.

Third, the Baker plan is increasingly giving birth to misdirected efforts like the Morgan junk bond business, the buyback that I regretted to see you commend.

Senator SARBANES. What I commended was their willingness to take an initiative and to try at least to do something, which I think is important.

Mr. DORNBUSCH. Mostly with respect to fee business, not productive economic measure but perhaps in the questions we can go to that.

PUBLIC POLICY

There is a big public policy issue in the solution. The first reason, of course, is foreign policy. Mexico, if one looks in Central America, Ecuador is sharply moving in the direction of Peru. Foreign policy is totally clear in the Philippines and in Brazil where it is less obvious but anyone who looks at the map does want to worry about it.

Public policy can't be excluded because the taxpayer is already deeply in without any question. When we lose exports, when imports increase, tax revenues fall, when banks stock valuation falls, tax revenues fall, so the taxpayer is deeply in and, as you rightly said, Mr. Chairman, the question is, what minimizes the burden on the taxpayer?

Now what are solutions? I don't believe that debt-equity swaps or buybacks are productive solutions and that is mostly an economic argument. I do see two important directions in which to move. One is the facility that you have advocated. I think that is an important direction in which to institutionalize the concern for doing something, doing sort of the opposite of the Baker plan.

I see two important roles for a facility. First, as a market maker to accelerate interesting opportunities and solutions, the most obvious one is to make debt terms more flexible, more conditional on economies' performance, growth and export revenues, something that should have happened when the contracts were written initially, something that could well be done now, something for which

someone has to give the nudge so that it happens. Certainly a facility would be ideal in doing that.

Second and specifically for smaller countries in Central America, I think there is an important role for a facility in helping achieve and passing on to the debtor countries the large discounts that already exist in the secondary market and if guaranteeing is involved that's probably a good security expenditure that one might take out of the military budget.

WRITING DOWN OF DEBTS

Now I do want to express, though, some concern about an excessive focus on the writing down of debts for this reason. Imagine that in Argentina one wrote down half the debt. What would happen to Argentina? Well, nothing, because they aren't paying that half which one would write off and they still have the same problems paying the half that they are paying now. Essentially, they won't have to go to the banks for new money, but they will have to now try and find the money that they really don't have to pay the half that they're trying to pay. They would, just as now, be facing hyperinflation. They would, just as now, have the same radicalization. I think that is a point that is not sufficiently emphasized, that in writing down merely means we're suspending the new money fund, that means accommodating banks who now think that's better for their stock market valuation, but we do absolutely nothing for the debtor countries. The priority for the debtor countries today is not that they are very concerned about their debt growing rapidly; they're worried about actually trying to pay the interest.

How can one go about that? Well, I think we have a wonderful opportunity with Mexico which because it's close on our borders is probably closer to our voters. Mexico has had extraordinary economic reform over the last 2 years even in an election year; a balanced budget, liberalization of imports, which is becoming a problem because it costs a lot of foreign exchange, selling off state enterprises—all the things that we do want to see. Mexico today is at a point where they need growth and they need it very rapidly. If they do grow, their current account which today still has a surplus, will go into deficit. At that point, it will be a question of servicing debt or growing. If that question arises, a lot of capital flight will take place and Mexico's adjustment program would simply go away.

Now that is only next year and we might say, well, why don't we wait until it's kaputt and then we can lament that they didn't really do everything right? Alternatively, we can take advantage of a new administration here, hopefully an open-minded one, to make an agreement that for several years—5, 6, 7 years—the Mexicans will pay every penny that they owe, but they will pay it in local currency investable in anything in Mexico except the oil fields which are a holy cow.

What would happen? Rather than running a large trade surplus to pay the full interest which Mexico is paying today, in the budget they still would be paying the interest, but now the bank creditors would be investing it in Mexico, therefore raising Mexican invest-

ment, therefore, supporting Mexican growth. If that were to occur, then of course the Mexican economy would be moving, foreign exchange crises would disappear, and as a result, private capital would come back. If private capital comes back, of course, it can be used to pay those banks who do want to get out.

I think we should, perhaps in the context of a facility such as you have recommended, look at recycling of interest payments as a reconstruction measure that makes it possible for those countries both to pay and to have the investment. If we don't do that, then I think Mexico in 1½ years will be where it was last year and that, of course, means a sharp political radicalization.

If in Mexico a program like this works, we have one good reason why countries should adjust and we can go from there to Brazil and to the Philippines and say here's a wonderful plan, the Dukakis plan or whatever you might call it, for countries to grow rather than to have hyperinflation as a result of debt servicing.

Thank you very much.

[The complete prepared statement of Mr. Dornbusch follows:]

with properly revalued developing country assets. It is the steady repayment by debtor countries as they resume growth that is ultimate guarantor of the financial soundness of the arrangement. Markets have probably been too pessimistic about their future service capacity.

The United States is not alone in searching for a solution, although better provisioned European banks and Japanese banks aided by dollar depreciation are less vulnerable than our own banks. A multilateral facility could and should attract Japanese and German capital, recycling such resources away from financing the United States deficit toward underwriting the recovery of indebted developing countries. It is a good investment. Within the context of its global model, the IMF finds that with increased finance (or reduced debt service) of $20 billion a year between 1988-92, "industrial countries as a group show a substantial and sustained rise in output." Japan and Germany are larger beneficiaries than the United States in increased growth.

In the last analysis, to walk away from the debt problem because it requires a modest industrial country input of resources is to abdicate responsibility. That is what got us into the debt problem into the 1970's in the first place when the problem of recycling petro-dollars was entirely left to private markets.

Developing countries have paid a high price for that decision through several years of slow and even negative growth. Increasingly, there is a domestic reaction in which external creditors are being singled out as the villains: how much longer

can austerity be pursued without provoking rejection of adjustment altogether. Banks are now much more willing to accept their share of the burden: their actions speak louder than their rhetoric of reassurance.

Left to themselves, and the private negotiating table, countries and banks can produce only inadequate and piecemeal progress as the last year has shown. Whatever the result in November, a new administration will not have the luxury of continuing to ignore the problem. It would do well to choose a more comprehensive and explicitly multilateral strategy in favor of debt reduction.

DEVELOPING COUNTRY DEBT PROBLEMS[1]

Rudiger Dornbusch
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Debt problems of developing countries and commercial bank creditors have entered a negative sum phase. The debtors cannot afford to divert further resources from investment to debt service and the creditor banks are poorly equipped to deal with the deteriorating quality of debts. Losses are made all around and the conflict calls for a policy intervention that makes everybody come out ahead: a solution must be found which makes debts better while assuring in the short run development finance, and hence a better long run ability to service debts.

Wider interests in a solution stem from the spillover of the debt crisis into foreign policy, our concern for the prospering of stable, democratic institutions in the debtor countries and the trade problems of the world economy. These broad interests justify public policy intervention. They make the case for citizens tax payers to take an open-minded interest in the problem and recognize that they all could loose significantly if the debt problem is allowed to deteriorate further. The market cannot easily generate a solution which reflects these wider concerns and that makes the debt crisis a public policy issue.

The muddling-through approach to the developing country debt problems, initiated in 1982 and institutionalized as the Baker Plan, is now longer productive. It has given banks time to build up capital against possible write-downs and has allowed creditors and debtors alike to gain a perspective on possible solutions. Most importantly, it has made governments in debtor countries appreciate the need for policy reform. In fact, progress is starting to show, at least in Mexico.

But today the debt service process has entered a negative sum phase: debtor economies are deteriorating under the weight of debt service and their creditors are receiving insufficient cash flow to come out ahead. The approach has not provided the financing required for growth and for fiscal stability in the debtor countries and thus has become unsustainable. The economic and political costs of a policy that puts debt service first, rather than reconstruction of the debtor economies, is no longer in the policy interest of the major creditor nations.

1. THE PROBLEM

The debt problem today shows itself in several aspects:

• Debtor countries cannot meet their debt service obligations. The government budgets and the external balances are strained. That strain is

[1]Testimony before the Senate Banking Committee, July 4, 1988.

apparent in high inflation rates, which are the counterpart of deficit finance and exchange depreciation required to transfer dollars abroad and in the sharp reduction of investment.

Table 1 Macroeconomic Developments in Countries With Debt Service Difficulties
(Annual average, percent)

	1969-78	1979-82	1983-86	1986-87
Real Per Capita GDP Growth	3.1	0	-0.2	1.4
Inflation	21.9	40.7	75.9	71.0
Investment as % of GDP	n.a.	24.9	19.0	19.4
External Debt % of GDP	n.a.	36.6	48.9	50.4
Resource Transfer Abroad, % of GDP	n.a.	-1.0	3.4	2.6

Source: IMF

A major acceleration of inflation is apparent throughout the debtor economies. Inflation rates have increased because the attempt to gain competitiveness through depreciation could not effectively be stopped from affecting domestic wages and prices. In many cases debt service was financed by outright money creation. The result of high, rising and uncertain inflation has been a very unfavorable climate for private markets. Financial considerations, not productive investment, are now in the forefront and capital flight has become pervasive. Brazil and Argentina are on the verge of hyperinflation already for the second time in only three years.

The attempt to find resources for debt service has come at the expense of investment. Investment has been depressed in debtor countries because governments have found it easier to cut investment budgets rather than raising taxes or reducing spending programs. The lack of growth, or outright contraction, and the disturbed financial conditions, have also depressed private investment.

The lack of investment has serious longterm implications. Low public sector investment builds up dangerous bottlenecks which stand in the way of an ultimate resumption of growth. Combined with the lack of private sector investment an imbalance develops between the strongly growing labor force and the ability of the economies to create employment at current, already depressed standards of living.

The financial instability that comes from strained budgets, high and rising inflation and frequent depreciation has proved a powerful incentive to

capital flight. Attempts to stem capital flight by high interest rates have brought about bankruptcy and budget problems. Sharply undervalued exchange rates which might stem capital flight in turn risk promoting political instability as a result of the very low real wages which this policy would imply.

• The past few years have allowed banks to raise their capital and thus be in a better position to cooperate in work outs of the debt situation. But even though they are better equipped to face the risks, they are reluctant to finance every year at least a portion of the interest payments. Reluctance to commit new money on the part of stronger banks conflicts with the inability of some other institutions who cannot afford a change in the debt service process. Thus the mechanism of concerted lending is strained and that strain creates uncertainties both in financial markets and in the debtor countries. Most concerted lending today is occurring in the emergency ward, with little concern for the economic viability of the process. The division of interest between banks in the U.S. and in Europe and Japan is becoming increasingly an obstacle in rescheduling. European banks favor interest capitalization or write-offs while U.S. banks want cash every quarter. Japanese banks, together with their government, favor a public policy solution.

The quality of debt has deteriorated. Even with an allowance for thin markets (which is less and less the case), Table 2 shows a sharp deterioration in debt quality.

Table 1 Prices in the Secondary Market for Bank Loans
(Bid price,Cents per dollar face value)

	7/85	7/86	7/87	7/88
Argentina	60	63	47	26
Brazil	75	73	57	52
Mexico	80	56	54	50
Peru	45	18	11	6
Philippines			68	54
Venezuela	81	75	69	55

Source: Shearson, Lehman Brothers and Salomon Brothers Inc.

• Debt service has taken the form of sharply reduced imports of debtor countries and a large increase in their exports. In creditor countries the superior (if involuntary) trade performance of debtors has added to protectionist sentiment. Manufacturing in creditor countries and the interests of commercial banks stand in outright conflict. Manufactures want to see large exports and reductions in imports from the debtors. The banks, by contrast, insist on debtor country surpluses for debt service.

• The current debt collection process poses political risks for the United States. The extent that the U.S. government is increasingly seen as the debt collector and as a result important foreign policy interests are

compromised. At the same time the debt collection process risks destabilizing center-democratic governments, moving political control to extreme groups. That has not been the case so far, but surely it is a consideration. New democracies in Argentina, Brazil and the Philippines and the political opening in Mexico are handicapped in their ability to develop programs of sustainable growth to support political and financial stability.

II. THE IMPASSE

The debt process today increasingly focuses on responsibilities of debtor countries to create economic conditions that allow market forces to transform the debt overhang into voluntary investment or asset sales. The Baker plan is opposed to any measure that could impair the return of voluntary lending. Any schemes to lighten debt burdens are disqualified on the grounds that they would make it virtually certain that debtors would be barred and banned from private capital markets for an extended period. But the belief in an early return of voluntary lending itself must now be questioned. Voluntary lending can only mean one thing: that debtor countries can borrow substantially all the interest they owe and, in addition, extra resources to finance development. Today the situation is the reverse: debtor countries are making large transfers abroad, impairing their growth potential and with it financial and political stability.

Creditors are withdrawing from increased exposure in Latin America even in those countries where debts have been serviced without interruptions and where even principal has been paid. Extraordinary difficulties of Colombia to roll over a small part of the principal of her debt, or the lack of success of the Mexican debt conversion, point to the fact that voluntary lending is altogether remote. Any program for solving the debt problem must, of course, recognize the implications for creditworthiness and the eventual return of the debtors to the world capital market. But these considerations should not stifle departures from the present strategy. In fact, a well-structured and market-oriented reconstruction program, with support by industrialized countries, will do much more for debt countries' creditworthiness than an unending sequence of debt rescheduling.

There is no natural break point for the current strategy. Often the deterioration in one country's willingness or ability to service debts is offset by an improvement in another country's performance. There always remains the possibility to speak of an improvement and there always is some indicator that shows genuine improvement, even if that indicator changes from year to year. These facts have been carefully exploited to keep the process going,but the debt situation is getting worse, not better. Ratios of debt to income have kept rising and are today above the levels of 1982 which, at that time, were declared excessive!

It is worth remembering that in the 1930s debt defaults were common. They were made more likely, as the Royal Institute concluded in 1937, by the lack of a prospect for renewed lending.

> "Maintenance of debt service upon the foreign capital invested in a country is affected by a number of factors. In the first place, creditors' receipts will be dependent not merely upon the ability but also the

willingness of debtors to pay. Many countries have discontinued service payments on their debts even when their financial position was sufficiently sound to enable such payments to be made. Usually, defaults have taken place when the possibility of obtaining fresh supplies of capital seemed remote, and when appearances suggested that there was little to be gained (except in prestige from the fulfillment of obligations."

Active policy intervention, including the increasing use of IMF and World Bank resources to patch up a basically unsustainable process have kept the Baker plan going and debt problems growing. The public interest in a solution is clear. The main question is the economic problems that requires a solution, what are the effective institutional structures to achieve this and how should the burdens be shared.

III SOLUTIONS

Unconditional, across-the-board debt forgiveness is an unproductive solution to the debt problem. It unfairly taxes creditors without giving any assurance of genuine economic progress in the debtor countries. But that does not mean one has to subscribe to the view that of all unsatisfactory ways of handling the problem the Baker Plan is best. There are more effective means to look after our interests.

The basic economic issue is to reduce or reverse the resource transfer from debtors to industrial countries and to achieve this objective in a manner that least damages the interests of the creditors. The existing, or "old" debt, represents a mortgage on debtor countries abilities to foster growth and profitable investment. New money will be reluctant to enter, unless (along with reforms in debtor countries) an effective means can be found to suspend the seniority of the existing debt.

Solutions to the debt problem must be designed to reduce the outward transfer of resources from developing countries. Thus can be done in one of three ways:

- A reduction in the debt principal burden and hence in interest payments, or directly a reduction in interest payments with unimpaired principal.
- Designing a more flexible schedule of interest payments.
- A separation of "old" and "new" money, by suspending the seniority claim of existing loans.

All three avenues are designed to modify the real resource transfer from debtors to creditors which today is too large and too inflexible. Market-related mechanisms to achieve these objectives have not shown themselves sufficiently up to solving the debt problem. That leaves two possibly complementary institutional directions to look for a solution. One is to move the government into a more central role using the framework of a debt facility. The other is to promote an automatic recycling of interest payments into investment in debtor countries, this should be done for countries like Mexico where stabilization has gone far enough to accept that debtors have done their part and that now creditors must contribute their share to a revival of growth and stability.

1. A Facility

The large discounts in the secondary market suggest the possibility of a refinancing of LDC debt. A facility, capitalized and guaranteed by industrial countries would play a role in helping debtor countries capture the discount while allowing creditor banks to achieve a more secure portfolio. There are essentially two variants. The facility could be merely a market maker or, more ambitiously, it could guarantee debts and thereby realize for the debtors a reduction of debt service burdens.

The Market Maker Role: A minimal framework is suggested by some authors of the trade bill. They see a role for a market maker or facilitator. They feel that with the help of a market maker (a bureau of standards and information, so to speak) more banks and more countries would avail themselves of the opportunities offered by the secondary market. Debtor countries would benefit to the extent that they capture a part of the discount associated with a refinancing.

The Mexican debt conversion scheme is perhaps the kind of deal that falls within the minimal scope which such an institution might fill. It would develop financially sustainable debt refinancing techniques, explore new means of satisfying regulatory requirements (and urge them on regulators and accounting boards) and develop techniques by which debtors can more securely guaranty debt service performance.

In principle private financial markets can fill this gap. But here is an area where a more visible and energetic intervention may well help shape and drive progress. This would be especially the case for arrangements to make interest payments more flexible. Existing debt contracts set fixed debt service schedules, geared to world interest rates. They create the possibility of illiquidity situations. These might arise from a transitory terms of trade decline, high world interest rates, or export losses.

If debt service schedules were more flexible in the sense that changes in objective indicators help trigger automatic capitalization of a portion of interest payments, then countries would be better placed to service their debts. This would be most obviously the case for transitory disturbances. But it would even apply when disturbances are not subsequently reversed since adjustment would be eased.

A scheme of flexing interest payments thus is eminently desirable. Of course, it increases commercial bank exposure-- lending more and for longer terms precisely at the time the borrowing countries have difficulties. Even so, lack of such flexibility is quite obviously not making the debts better and risks confrontation, moratoria and even default. Restructuring existing debts in this direction would be an important change.

A restructuring is most obvious for those countries where a single world price, say the price of oil, has a major effect on the balance of payments, real income and public finance. But the method can be carried over in a more general fashion by using the growth rate of per capita income, for example, as the benchmark that governs debt service. Another possibility, highlighting in particular the external transfer problem, would use export earnings as the benchmark for triggering changes in current debt service liabilities.

Flexibility can also be used in those cases where continued debt service on contractual terms seems totally precluded-- say Bolivia or Peru to give examples. Reducing current debt service, which is not paid anyway, is desirable because it enhances macroeconomic stability. But there should be a counterpart: in exchange for a reduction of current debt service, the country undertakes to resume full debt service (possibly including capitalized interest) if debt service possibilities improve beyond a specified threshold. Thus creditors keep the option value of any improvements in the debtor countries as partial offset to their current sacrifice of interest earnings.

A Debt Guarantee and Refinancing Facility: A more comprehensive role involves the facility in buying from commercial banks claims on developing countries at significant discounts. These debts would then be renegotiated with the debtors to pass on to them the discount. The renegotiated debt involves a present value equal to the obligation incurred by the facility toward the commercial bank, but there could be a better time shape and contingencies of payment so as to enhance flexibility.

This larger role for the facility poses a difficulty. Tax payers in developed countries would have to underwrite the default risk. Even if the renegotiated debt has a present value equal to the trust's commitment toward the initial creditors, there is a risk of nonperformance. Tax payers would have to absorb that risk. That risk, however, might be reduced to a very small probability if the trust is structured in a way that has it share disproportionately in favorable outcomes in the debtor countries.

An important advantage of a facility is the possibility of influencing debtor country adjustment by suitable conditionality. The leverage for a new, more productive conditionality is twofold. First, there are direct interest savings that come from debt reduction. Second, the trust could subordinate its claims to flows of new money that would be part of an approved reconstruction program. By removing the seniority of existing debt (and that of banks who hold out) the facility would help reverse the pattern of international transfers and allow a resumption of development finance.

The facility could also reduction in debt principal and hence debt service requirements. An alternative possibility envisages a fund which guarantees interest payments rather than principal. The trust might for example guarantee over a horizon of three years interest payments on the external debt of a country. In exchange for the guarantee there would be a significant reduction of the amount of interest due. This might be done by balancing current cash flows-- the fund receives from debtors reduced funds and passes these on to banks who are protected by the guarantee. In a more ambitious role the fund could play a role as a capitalizing agency. In this system reduced, guaranteed payments are made to the banks on a predetermined time schedule. But the debtor countries payments, while reduced in present value, might have a more flexible time schedule to take into account the current ability to pay. Once again, there need not be any subsidy element in this scheme other than the guarantee, the latter having possibly an offset in special fees levied on countries in particularly favorable conditions.

The Free Rider Problem: A debt service reduction facility will not easily emerge as a market outcome. There is an intrinsic free rider problem. If many

banks were to participate, and as a result significant debt service reduction were to take place, any individual bank would have an incentive not to participate. The debt service reduction of all the participants frees resources to pay the full claims of all those who have stayed out of the arrangement. As a result, as the Mexican auction demonstrated already, debt reduction as a market outcome will be insignificant. To achieve a major debt service reduction by this method it has be imposed by a debtor country on the creditors or else regulators and legislators in developed countries must lead banks to participate with carrots and/or sticks. The former method was common in the cleaning up of debts in the early postwar period, following the extended suspension of debt service. At the time agreements were reached with bond holders councils and nonparticipant bond holders did not receive special treatment.

The alternative is for legislators and regulators in creditor countries to take the initiative and assure participation by a significant share of the creditors. This can be achieved either by creating incentives for participation in the form of regulatory advantages and an extended period during which loss provisions can be made on the side of capital retirements and losses can be carried forward for tax purposes. Alternatively regulators and legislators could impose costly capital and tax rules for nonparticipating banks. One way or the other, the free rider problem must be addressed. There is also a free rider problem in respect to governments. Much of the discussion about debt reduction facilities has focused on commercial bank claims. But, as noted above, even in the major debtor countries official claims amount to more than a quarter of total debt. Hence it is entirely appropriate to ask what treatment official debts should receive in this context. A distinction might be made between claims of the World Bank and the IMF and direct government debts. The distinction is appropriate because a write down of World Bank claims would potentially harm the interests of much poorer countries.

The Tax Payer: It is commonly argued that the tax payer in industrial countries cannot and should not participate in any solution to the debt problem.

That position amounts to an overly narrow and shortsighted view. The tax payer is already participating because bank losses have tax consequences as do the trade and foreign policy implications of the debt crisis. Attempts to use the World Bank as a financial resource, filling the gap left by the banks is a barely concealed means of using tax payer resources. Most obviously, however, a major financial crisis precipitated by an uncontrolled development on the debt front could lead to financial distress throughout the world economy. This scenario is not the most probable, and it is even unlikely. But there is enough financial vulnerability in capital markets today to take it seriously. The damage to the industrialized countries' economies and the resulting consequences for tax payers would be open-ended.

The active issue therefore is what particular direction of change strikes the best bargain, using (inevitably) tax payer dollars to secure economic, financial and political interests. This is not an argument to volunteer tax payer resources; it simply is a realistic assessment that the tax payer is already deeply involved and that quite possibly further commitments may limit the ultimate damage.

Senator SARBANES. Thank you very much.
Mr. Islam.

STATEMENT OF SHAFIQUL ISLAM, SENIOR FELLOW, COUNCIL ON FOREIGN RELATIONS, NEW YORK, NY

Mr. ISLAM. Thank you, Mr. Chairman.

I appreciate this opportunity to share my views with you and your colleagues on the international debt problem. In my oral remarks I will briefly comment on three issues. One is the shortcomings of the current approach. Second, the shortcomings of the market response to the shortcomings of the official approach; and finally, the need for a alternative debt strategy to support policy reforms in the debtor countries with large-scale coordinated debt reduction on a case-by-case basis.

MYTH OF TWO POLICY APPROACHES

Mr. Chairman, I want to begin by debunking a myth. That myth is that there are essentially two policy approaches for resolving the debt problem for the middle income countries. The case-by-case approach which the current administration and the other major creditor governments support, and the so-called globalized, generalized, and comprehensive schemes which they reject.

Mr. Chairman, the real choice is not between the case-by-case approach and a generalized approach, but between a case-by-case approach to concerted bank lending and a case-by-case approach to concerted debt reduction. The fundamental problem with the current debt strategy is not the case-by-case approach. In fact, I think that is the way to go, but that a liquidity solution is being applied to what is increasingly becoming a solvency problem. In other words, while many of these countries cannot fully service their current debt level—that is, they suffer from a debt overhang—and thus need debt reduction, they are being offered debt expansion, further compounding the debt crisis.

Contrary to official claims, Mr. Chairman, the current debt strategy is not promoting growth and creditworthiness in the major debtor countries, but undermining them. One of the major reasons for that is Washington's insistence that debt overhang must be serviced in full. As a result, policy adjustment to service the debt overhang are damaging the environment in which a country can pursue genuine policy reform that generate growth. In other words, adjustment to service the debt are paralyzing the economic health which growth oriented policy reform is supposed to restore in the debtor countries.

The shortcomings of the current approach, Mr. Chairman, is being increasingly recognized by the private banks and their stockholders. A secondary market for LDC bank loans has thus emerged and developed as banks increasingly attempt to reduce or eliminate their exposure. While Secretary Baker, frustrated with "forced lending" fatigue, gave his official blessing for "the menu approach" to raising new money in April 1987, banks have since shown more interest and ingenuity in enhancing the menu in reducing old debt. By participating in the Mexico-Morgan deal in the last winter, the

U.S. Treasury has now followed the market and placed voluntary and market-oriented debt reduction on Baker's evolving menu.

PROBLEMS WITH MARKET MENU APPROACH

But, Mr. Chairman, there are two problems with the market menu approach debt reduction.

First, the market approach to debt reduction proceeds in a marginal and uncoordinated fashion, and therefore the debtor country cannot adequately design, let alone implement, the much encouraged growth oriented structural reforms within a medium-term framework.

The second problem is that the market's menu fails to fully translate debt reduction into debt relief. Part of the discount often escapes the debtor country and ends up in the hands of another foreign bank or a foreign multinational company, and thus represents missed opportunities for translating bank losses into debt relief.

So, Mr. Chairman, the dangerous dilemma posed by the official involuntary new money plus involuntary resource transfer approach can be eased, and the market failure of the market's menu approach to maximize the systemic welfare gains can be corrected by voluntary coordinated case-by-case approach to debt restructuring and debt reduction.

Let me sketch five major building blocks of this approach which is very much along the lines of Nicholson's proposal as well as in the spirit of the congressional initiative in the trade bill that is now becoming law.

One, I propose that the United States and Japan—which has been increasingly able to assume greater global responsibilities—would create a debt facility which will act as a political mediator, financial intermediary, and a debt guarantor. This G–2 facility is politically and operationally more feasible than an administratively complex international debt discount corporation. Once in operation, this G–2 embryo can develop into a full-fledged multilateral facility as more debtor countries seek relief and more creditor countries seek membership.

Two, the facility would operate much the same way the various IMF loan facilities work. When a middle income debtor country decides it needs debt relief, it would submit to the facility a letter of intent, prepared in consultation with the facility and the Fund/Bank staff, detailing a program for policy reform supported by debt service reduction. If the board accepts the letter of intent, it would arrange negotiation with the creditor banks for concerted exposure and debt reduction.

Three, the banks would exchange at par—and this is the point that the principal reduction or write-down is not very helpful, what is necessary is interest reduction up front, their floating-rate, longer-term sovereign loans for bonds issued by the facility with long maturities and fixed below-market rates, 4 or 5 percent. The spread between the market rate and the coupon rate on the bonds will determine the implicit discount the banks will offer.

Four, the country would now service its restructured debts using the facility as the intermediary. That is, the facility would pass on

the bank losses as debt relief to the country in the form of reduced interest burden.

And finally, Mr. Chairman, the required reduction in the interest bill and the implied relief from resource transfer should be negotiated on the basis of the following two criteria: Restoration of growth and investment consistent with efficient and high utilization of the country's domestic resources; and freeing private banks from the Ponzi trap of providing forced balance-of-payments loans to the country to finance their own interest earnings. This is the point I think has been made this morning.

POSITIVE FEATURES OF THE PLAN

Mr. Chairman, I would like to highlight four positive features of the plan.

First, the plan should cost American taxpayers almost nothing because banks will take losses as they strengthen their balance sheets by replacing risky loans with safe bonds. To be sure, with the facility guaranteeing the bonds, the G–2 governments initially will shoulder the much-reduced risk of the debtor country's restructured and reduced obligations. However, the ultimate financial burden of this risk or guarantee should be zero, as the whole point of this approach is to design a program to ensure that a country receiving relief has no incentive to default on its remaining debts.

So, Mr. Chairman, I would submit that this plan will actually bail out the taxpayers who are already deeply in, as Professor Dornbusch said, and not the banks.

In my written statement I discuss the capital and the operational costs that may be generated by this facility, with Japan taking most of the burden. I would say that the U.S. obligation to disbursement could be about $15 to $20 million per year. The bottom line is that the budgetary burden of capital and operational costs of this facility would be negligible compared to the economic, political, and strategic benefits that the United States will gain from improved growth and social stability in the debtor Third World.

The second point is that the plan will not pose any threat to the survival of banks with heavy LDC exposure.

Senator SARBANES. Mr. Islam, I'm going to have to interject. All these bells, lights, and beepers that are going off are indicative that there's a vote on the floor of the Senate. I think what we're going to have to do is suspend. We will go vote and we will return. I was hoping I would hear out the full statement before we had to go, but we will have to go. We will come back and hear the balance of your points and then we'll go to questions for the panel. So we will take a brief recess and if the panel members will be patient we will be back very shortly.

[Recess.]

Senator SARBANES. The subcommittee will resume.

Mr. Islam, we will hear the balance of the statement. I apologize for the interruption but it was beyond our control.

Mr. ISLAM. No problem.

Senator SARBANES. I take it you're nearing the end of it.

Mr. ISLAM. OK. I will try to finish up quickly. I was making the point that the plan will bail out the taxpayers and not the banks.

Senator SARBANES. That was your first of four points, right?

Mr. ISLAM. That's right. The second point I was making is that the plan will not pose any threat to the survival of banks with heavy LDC exposure. The reasons are that these banks now are much stronger because they have beefed up their capital base, set aside loan loss reserves, and now increasingly charging off and selling bad loans. Bank stock prices reflect substantial writedowns in LDC loans. The actual write-offs will only mark the banks' LDC exposure to the market. To make marking-to-market as painless as possible, I suggest that banks can be permitted to stretch out their losses and reduce their tax burden, say, over a 10-year period on an internationally equitable basis within the BIS efforts for international regulatory reform.

The third positive feature is the plan avoids the much feared moral hazard problem that the bad behavior of a debtor country will be rewarded. The debtor country buys debt relief with a commitment for policy reform and acceptance of greater Bank/Fund surveillance. But more importantly, after debt relief is given, badly needed new money from official sources to finance reform and development would remain conditional on carrying out those policy commitments. In other words, while conditional debt relief would lighten the counterproductive burden of the debt overhang, it would tighten the room for bad behavior by policy strings attached to the flow of new money.

Finally, let me note, Mr. Chairman, this plan represents a case-by-case, voluntary, flexible, market-oriented, cooperative and balanced approach to serve the community of enlightened self-interest. And it does not represent a wholesale solution, grand design, quick fix or panacea. In fact, it offers a realistic way out of the maze of code words and cliches used to defend the bankrupt strategy of rescuing the insolvent countries. The purpose of this plan is not to put forward a definitive solution, but to present a framework of reasonable guidelines that could be modified, refined, and further developed by a process of constructive dialog.

Mr. Chairman, let me conclude by briefly commenting on the politics of the proposed approach and the U.S. foreign policy costs of the current debt strategy. I have so far focused on the financial and economic aspects of the proposed approach, but I believe that it is politics that will ultimately determine its success. We should not forget that the debt crisis itself is a phenomenon of market failure, and thus the market left to itself will resolve it in a very costly manner.

An indispensable ingredient in making this approach work is political leadership, both by the debtor governments seeking relief, and by the creditor governments supporting it.

I just want to make the point that the debtor governments have to provide the political leadership in developing the necessary package and implementing it, while the other side of the coin is political leadership in the creditor countries, and particularly in Washington.

The United States must provide the necessary leadership in supporting and implementing this approach. Without U.S. leadership

and support, this approach cannot emerge, let alone develop. But more importantly, leadership breeds leadership. With correct signals from Washington, the other major creditor governments, as Mr. Nicholson pointed out, particularly Japan, can also come forth with new ideas and new money. Moreover, visionary leadership in Washington can catalyze courageous leadership in Brasilia, Mexico City, and Buenos Aires.

The current debt strategy has already begun to take its toll in Latin America. Even with large-scale fraud, the ruling party in Mexico barely won the recent election, and has lost its long-held popularity. The debt crisis has polarized Brazil with the next year's election likely to bring either the left or the right into power. In Argentina, the ruling party is also paying the price of the current debt strategy; the populist wing of the Peronist party is closing in to win the next year's election with the pledge of a 5-year moratorium on the nation's foreign debt. The U.S. foreign policy costs of sticking with the current strategy can be disastrously high as the debt overhang increasingly threatens democracy in Latin America and the Caribbean with 19 changes in governments scheduled by the end of next year.

We are here also in the middle of changing administration in this country, but I think that time is running out fast in the nations to the south of our border. If the U.S. Government wishes to promote political stability and protect democratic institutions in Latin America, the new administration needs to act sensibly, and act fact.

Mr. Chairman, let me end by warning that if the U.S. continues to make the wrong choice between debt and democracy, the consequence could be confrontational defaults, global economic instability, and resurgence of dictatorships in Latin America and in other parts of the Third World.

Thank you.

[The complete prepared statement of Mr. Islam follows:]

7. Recycling of Interest Payments

Today debtor countries are paying, on average, half the interest they owe. Their debt service raises two problems. First, debt piles on top of debt as part of the interest due is financed by new loans. Second, the resource transfer abroad required by the portion of interest that is actually paid comes at the expense of investment and stability in finance. But for a country like Argentina a program that achieves a significant write down of debts, say 15 percent, does nothing to solve the transfer problem. It could therefore come as a major shock that, following a renegotiating and reduction of its debt, a country like Argentina is just as unable to pay the remaining interest due as she is today.

This difficulty is best addressed by a fundamental restructuring of debt service which addresses the near-total of interest payments due. Actual payments in dollars would be reduced to the service of trade credit and possibly the loans of multilateral organizations. The remaining interest payments would in part be capitalized, thus freeing resources for much needed public sector investment, and in part they would be made in local currency. Creditors who receive the local currency payments could use them for unrestricted investment in the debtor countries' economies. The only limitation on the use of funds would be that they cannot be transferred abroad. The claims to these payments could, however, be sold. Basically this scheme amounts to a debt-equity swap applied to interest payments rather than to the principal. It amounts to a recycling of interest payments to finance reconstruction and development.

The advantages of the interest recycling are threefold. First, the transfer abroad of resources is suspended. Rather than running trade surplus debtor countries have resources freed that can be devoted to investment. Of course, serious budget action is required to assure that in fact the resources go into investment rather than consumption. The shift of resources toward investment has two effects. It implies an expansion in capacity and thus sustains job creation. This issue is central in economies where labor force growth rates of 3 percent have created major imbalances between labor supply and the demand for labor. The expansion in capacity removes the bottlenecks which today stand in the way of growth. Growth in turn translates into more stable public finance via a broadened tax base.

The second advantage of the scheme is to create a more stable and prosperous business environment. In the current strategy a foreign exchange bottleneck is always around the corner and the reaction is invariably contraction of demand and exchange depreciation. This reality has led to disinterest in productive investment and extensive capital flight. The center of gravity has shifted to financial markets, far away from productive activity. By removing the need for immediate debt service the debtor economy can resume a more balanced position with an emphasis on long-term investment and growth. As a lever for reducing capital flight there is no better way than a restoration of business confidence and an end of exchange pressure.

There is a third, once and for all gain. In the present situation the need to maintain very depreciated real exchange rates translates into inflationary pressures and low demand in the debtors' domestic markets. The

removal of external constraints allows some real appreciation and hence provides a breathing space for stabilization of inflation. Inflation stabilization is, of course, an essential step in a restoration of normal business conditions.

For creditor countries the reversal of trade surpluses has immediate interest; it means that exports from developing countries will decline and imports, especially of capital goods, will rise. Thus recycling provides the financial underpinnings for solving at least a part of the world trade imbalances.

As a counterpart for acceptance of this scheme by creditors (or to make it more acceptable, in case of unilateral action) debtor countries would have to accomplish two things. First, they would have to overcome nationalism and undertake the necessary legislative reform to provide leeway for private foreign investment in their economies. Second, they would need to achieve a serious budget reform that frees resources (through more efficient broader base taxation and through cuts in wasteful spending) that become available for foreign creditors' investments. Both policy reforms are highly desirable. There should be no misconception: debtor countries would have to undergo major policy reforms to translate the leeway provided by recycling into productive investment. There might be a temptation to dissipate the resources into a restoration of consumption after so many years of deprivation. But that would be unacceptable. Toughminded fiscal measures, and broad based liberalization of investment opportunities are the quid pro quo for the suspension of resource transfers.

A program such as this could be seen as a reconstruction program of the kind administered after World War I or World War II. It would extend over a decade or so. Ultimately creditors would be able to recover their principal and accumulated earnings with a guarantee of no frivolous exchange losses.

The basic case for this program is the emphasis on reconstruction. It is apparent that debtors today are not improving their ability to service debts. Debt is becoming politicized and the prospect for early, full and unimpaired recovery of the loans is simply nonexistent. The creditors' interests are best served by a reconstruction program, but the current negotiation process does not lend itself to restructuring debts in a productive way. As a result policy intervention (or responsible unilateral action) is necessary to break the deadlock. This would be a dramatic change in policy. As such it would require a major effort on the part of debtor countries to contribute their share to reconstruction and eventual debt service.

For the major debtors (like Mexico, Brazil and the Philippines), there is no presumption that debts must be written down. There is an urgent need to create conditions for growth. Whether debt is excessive, once growth does come under way is a matter that can only be judged later. The almost exclusive focus on debt reduction rather than a restructuring of interest is counterproductive. It allows supporters of the Baker Plan to argue that their proposals are more realistic than blanket debt reduction for countries where capital flight is endemic. As a result nothing is done and the economic and political costs of the debt crisis mount. A businesslike solution for many debtors is a recycling of interest payments. It is more realistic than the promise of major involvement of the tax payer. It is a powerful lever for policy reform. It is automatic and its benefits show up in increased investment almost instantly.

APPENDIX

Table A-1 Key Indicators for Developing Highly Indebted Countries

Country	Debt					Per capita	Debt
						GNP	Service
	Total	Ratios			Total per	(Atlas	Ratio
		XGS	XGS	TDS/	capita	method)	(percent)
						1986	1986
Argentina	51.0	4.4	3.1	0.6	1,540	2,130	44
Bolivia	4.4	3.2	2.9	0.4	1,000	570	41
Brazil	121.1	4.1	2.8	0.3	1,000	1,810	34
Chile	20.3	2.3	1.6	0.1	1,660	1,390	21
Colombia	15.1	1.7	1.4	0.1	1,010	1,240	24
Costa Rica	4.1	2.1	1.4	0.1	1,700	1,810	24
Cote d'Ivoire	8.1	3.1	2.4	0.1	1,000	770	24
Ecuador	8.9	3.1	2.4	0.2	1,130	1,160	34
Jamaica	3.9	3.1	2.7	0.2	1,540	1,160	24
Mexico	100.9	4.0	3.0	0.2	1,210	2,080	34
Morocco	17.0	3.3	2.5	0.2	1,000	610	24
Nigeria	7.1	1.8	1.3	0.1	1,170	1,160	24
Peru	14.1	3.3	2.5	0.1	1,000	1,160	24
Philippines	26.0	2.4	1.8	0.2	1,000	1,160	24
Uruguay	4.4	3.3	2.5	0.1	1,000	2,130	24
Venezuela	33.4	2.1	1.4	0.1	1,000	2,130	24
Yugoslavia	21.9	2.1	1.4	0.1	1,000	2,130	24

Note: 1/ Debt outstanding at end of year, 2/ Outstanding debt/exports of goods and services, 3/ Interest payments/exports of goods and services, 4/ Total debt service/GNP, 5/ Net disbursements/net resource inflows.

Source: World Bank World Debt Tables, 1987-88 and Development Prospects and Capital Flows.

Alternative Representation Commercial Credit Industrial Production Lending Country

Overcoming the Debt Overhang -- On a Case-by-Case Basis

Statement by

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Before the
Subcommittee on International Finance and Monetary Policy
US Senate Committee on Banking, Housing, and Urban Affairs

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The Debt Crisis and the Official Response

Six Summers ago, Mexico suspended servicing its debt to commercial banks and precipitated what has become known as the Third World debt crisis, or more generally, the international debt crisis. From the beginning, there were two potential victims -- creditor banks and debtor countries. The initial response of the official creditor community was to put together "austerity with financing" packages to save the first victim from the threat of immediate insolvency. The strategy worked, but improved solvency of the banks came at the expense of growing insolvency of the countries. It became increasingly clear that one potential victim of the debt crisis has been saved by turning the other into an actual victim.

The official response to this disturbing development was the October 1985 speech by US Treasury Secretary Baker, widely known as the Baker Plan. The Plan emphasized growth over austerity in the debtor countries, and more "new money" from the commercial banks and the multilateral financial institutions to finance

"market-oriented policy reform." With three years of "growth with adjustment" under the Baker Plan, it now appears that it is mostly adjustment, not growth, that the debtor countries have experienced, with further damage to their social fabric and political stability.

Meanwhile, solvent banks have become increasingly reluctant to lend to insolvent countries, thus producing "a crisis of creditors" as the crisis of development and democracy has deepened. The official debt managers themselves now admit that the current debt strategy has fallen victim to "debt fatigue." Perhaps a more revealing characterization of today's reality is that while the debtor countries are suffering from "adjustment fatigue," the banks have been infected by "financing fatigue."

The official admission of the failure of the current debt strategy has found its latest expression in the Toronto Summit with the seven heads of state agreeing that, "The problems of many heavily indebted developing countries are a cause for economic and political concern and can be a threat to political stability in developing countries." For the poorest debtor countries, especially those in Sub-Saharan Africa, the Seven Summiteers have gone a step further -- they have endorsed concessional interest rates, longer repayment periods and partial write-offs for those countries' largely official debts.

For the middle-income debtors (concentrated in Latin America), however, the heads of state have failed to go beyond admitting that these countries "continue to have difficulty servicing their external debt and generating the investment necessary for sustainable growth." Apart from endorsing the

"menu approach" which "has engendered new financial flows, and in some cases, reduced the existing stock of debt," the leaders reaffirmed their commitment to "the market-oriented, growth-led strategy based on the case-by-case approach."

Thus the seven chiefs of state once again recycled the widely accepted myth that the two policy alternatives for resolving the debt problem of the middle-income countries are "the case-by-case approach" which they support, and the so-called "global, generalized and comprehensive schemes" which they reject. The real choice is, however, not between a case-by-case approach and a generalized approach, but between "a case-by-case approach to concerted bank lending" and "a case-by-case approach to concerted debt reduction." The fundamental problem with the current debt strategy for the middle income countries is not the case-by-case approach (indeed, the case-by-case approach is the way to go), but that a "liquidity solution" is being applied to what is increasingly becoming a "solvency problem." That is, while many of these countries cannot fully service their current debt level (i.e. they suffer from a debt overhang), and thus need debt reduction, they are being offered debt expansion, further compounding the debt crisis.

Official Strategy: Liquidity Solution to a Solvency Problem

The official debt strategy for the middle income countries suffers from two fundamental problems. One, it forces the "overborrowed countries" to borrow more and transfer scarce domestic resources to service old debts that are not generating

new income. And two, it forces the "overexposed banks" to further increase their exposure with new loans which may not generate future earnings. Thus the current strategy of "siphoning resources from productive uses" and recycling "good new money" to service "bad old money" postpones and compounds the eventual settlement of losses from past overborrowing and overlending as countries and banks are forced to do more of what they have done to create the problem in the first place. It perpetuates a twin crisis of development and finance as "unsound adjustment" is pushed with "unsound money."

The "resource transfer" plus "new money" approach to managing the twin overhang of debt and exposure presents the countries as well as the banks with a disturbing intertemporal choice. If a country "succeeds" in obtaining more new money, it is able to reduce resource transfer, expand investment, and thus strengthen the future capacity to service the debt overhang. But it also ends up with higher future obligations to service even a greater debt overhang. If the country "fails" to obtain more new money, and is forced to transfer more resources, its servicing obligations grow less rapidly, but the future capacity to service the debt overhang also weakens. Thus "the resource-transfer-cum-new-money approach" to manage the capacity-obligations gap presents the country with a debtor's choice. It can improve its future debt servicing capacity, but only by shouldering a greater debt overhang, or it can stop the rise of the debt overhang, but only by damaging its future capacity to service that overhang.

Similarly, if the banks "fail" to provide more new money, they reduce the growth of their "exposure overhang", but at the

Table 1

Economic Performance and Debt Burden in Fifteen Problem Debtor Countries, 1965-1985
(In percent, unless otherwise specified)

	Reference	Toward Crisis			Imbalance Austerity			Toward Growth?	
	1970-73	1980	1981	1982	1983	1984	1985	1986	1987
Macroeconomic Performance									
Per Capita Real GDP Growth	3.3	2.4	-1.9	-4.0	-4.9	-0.2	0.5	-1.2	-0.3
CPI Inflation Rate	32	47	54	56	92	118	121	77	116
Gross Capital Formation (percent of GDP)	25	25	25	22	18	17	17	18	17
Asymmetry of Debt Service									
Debt/Export Ratio[1]	1	168	202	268	295	269	287	344	325
Interest/Export Ratio[2]	1	16	23	31	25	29	28	29	28
Terms of Trade Growth	-5	0	-5	-4	-4	1	-3	-10	2
Merchandise Trade Balance[3]	1	6	-7	4	28	42	41	21	28
Exports[4]	128	127	112	111	123	119	100	112	119
Imports[4]	122	134	108	83	83	78	74	85	91

Note: The countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.
[1] Compound annual rate of change
[2] IMF forecast
[3] Export represents exports of goods and services.
[4] Includes interest incurred, but not paid (arrears).
Billions of U.S. dollars

Source: World Economic Outlook, IMF, April 1985

expense of an immediate threat of arrears, moratoria and defaults. If they "succeed" in providing more new money, they lower the imminent risk of arrears and moratoria; but at the expense of further growth of their exposure overhang. Thus the banks also face a disturbing trade-off between lower exposure overhang accompanied by greater risk of immediate default, and lower risk of immediate default accompanied by a greater exposure overhang.

From a systemic standpoint, the official debt strategy attempts an intertemporal shift of losses resulting from the debt overhang on development and bank finance: banks' loan losses are postponed by realizing development losses now. Such intertemporal shifting of losses on loans that have already gone sour, however, turns out not to be a zero-sum game, but a negative-sum game. That is, the strategy lengthens the crisis, not by a permanent alleviation of the crisis, but by rescheduling it for the future. Put simply, the crisis is dragged out as it deepens under the surface, taking its actual toll on the debtors and accumulating its potential toll on the banks, threatening to resurface later with a greater intensity, forcing a violent and destructive resolution.

Official Strategy: Economic Costs of Servicing the Debt Overhang

There is plenty of evidence that the official debt strategy is not promoting growth and creditworthiness, but undermining them. Table 1 documents "progress" in overcoming debt and development problems by fifteen middle-income debtor countries before and after the Baker Plan offered them the road map to

"growth with adjustment." Three points deserve special attention.

First, with all the policy adjustments and policy reform -- and in many cases because of the policy actions -- economic growth and investment have suffered and inflation has risen to astonishingly high levels. Per capita income declined four years in a row before the arrival of the Baker Plan, and after a modest rebound in 1985-86, declined again last year regressing to the level of the late 1970s.[1] The rate of investment dropped precipitously during 1982-84, and has failed to recover under the market-oriented policy reform of the Baker Plan. Despite much belt-tightening, resulting in high unemployment and massive excess capacity, inflation rose six years in a row to 120 percent in 1985, and the IMF expects it to reach a record 160 percent this year. In short, while the creditor countries have continued their recovery, life in the debtor countries has not been any better under the growth-oriented Baker Plan -- per capita income has failed to recover, investment has remained depressed and inflation has soared.[2]

Second, year after year, the debtor countries have generated enormous trade surpluses as scarce domestic resources have been transferred abroad to service the debt overhang rather than to

[1] With the Baker Plan for "growth with adjustment" now firmly in place for almost three years, the IMF is forecasting yet another year of no per capita income growth in 1988.

[2] Needless to say, the aggregate data mask a great deal of cross-country differences, but the overall story is the same -- depressed income, employment and investment, and unusually high and volatile inflation. While poor macroeconomic performance in the debtor countries cannot be blamed entirely on the current debt management strategy, it is widely recognized that the pressure to service foreign debts has contributed to depressed growth, stubbornly high inflation and macroeconomic policy instability.

finance investment and support "growth-oriented policy reform." Furthermore, this resource transfer has been accomplished not by export expansion, but by import compression. For example, the almost $50 billion "improvement" in the trade balance of the 15 "Baker Countries" during 1981-1985 was generated by a $55 billion cutback of imports. And despite all the rhetoric of "exporting out of the debt problem," exports in 1985 were $8 billion lower than in 1981, and have since declined further under Secretary Baker's growth-oriented adjustment plan.

Finally, the official strategy has failed to stop the rise of the debt overhang and has made little dent in the cost of servicing it. The debt/export ratio of the fifteen Baker countries was around 170 in 1980, a year in which there was already growing concern that the debt burden was too high. In 1982, the debt crisis broke with a ratio of 270. Three years of forced lending pushed the debt ratio to 290 in 1985. Now with "growth-oriented structural reform" supplemented by more forced lending, the debt ratio has reached new heights, ranging between 330 and 345 over the last two years.

Furthermore, even with declining dollar interest rates, the Baker countries have seen little improvement in the interest/export ratio. While the interest bill claimed 15 percent of export earnings in 1980, it shot up to 30 percent in 1982 -- a burden that these countries have now been bearing for six years with some countries receiving occasional relief not from the Baker Plan, but by slipping into quiet arrears and by imposing not-so-quiet unilateral moratoria. In sum, while the official rhetoric continues to emphasize progress of "the

market-oriented growth-led strategy," the reality points to rising debt overhang and cripplingly high servicing costs compounding the debtor's vulnerability to adverse internal and external shocks.

The debt overhang also creates a little-understood macroeconomic policy conundrum. While the creditor governments, bankers and experts constantly exhort the debtor countries to carry out appropriate "policy adjustments," most fail to recognize that there are in fact two types of adjustments: "policy adjustments to service a debt overhang" (counter-productive belt tightening) and "policy adjustments to generate growth" (productive bodybuilding). One paralyzes the debtors' capacity to pursue the other. That is, debt-servicing policy adjustments damage the economic health which "growth-oriented policy reform" is supposed to restore.

The key reason is that draconian measures required to service the debt destabilize the macroeconomy. Currency devaluations to generate trade surpluses put upward pressure on inflation and nominal interest rates, and raise the government's local-currency interest bill on foreign debts -- a major source of large budget deficits in many countries. The widening budget deficit leads to inflationary monetization, requiring more currency devaluation, and more fiscal and monetary austerity.

As greater fiscal austerity is pursued by cutting non-interest government expenditures, the economy slumps causing revenues to shrink and frustrating the goal of deficit reduction. Also, with increasing success in paring the non-interest expenditures, the share of interest payments in the

overall budget goes up, leaving progressively less room for achieving future success in deficit reductions. As the ballooning interest bill on foreign debts remains untouchable, the battle to reduce the budget deficit never ends, with fiscal policy continuing to drag the economy downward.

Monetary tightening and real interest rate hikes to fight inflation and capital flight further depress the economy, again pushing the fiscal deficit up. The vicious cycle of recession-inflation-deficit-depreciation undermines business confidence and encourages capital flight, putting additional negative pressure on growth and the balance of payments.

In sum, servicing the debt overhang creates a perpetual cycle of policy adjustments, where today's adjustments creates the need for further policy corrections tomorrow. Consequently the debtor countries experience a "hysteresis of solvency," where suffering through today's solvency problem creates a bigger solvency problem tomorrow, leaving less room for genuine policy reform.

Market Response: Marginalist Uncoordinated Debt Reduction

Private banks have increasingly recognized the long-term risk to their capital base and profitability posed by the deteriorating debt overhang. Many large banks in Continental Europe and several small regional US banks have long reserved against or written off much of their loan exposure to the heavily-indebted developing countries. Despite strong pressure from the stock market, US money-center banks had been slow to respond, but Brazil's February 1987 moratorium on interest

payments spurred Citicorp to reserve $3 billion against its LDC exposure, forcing an avalanche of loan-loss reserves among other major US and British banks.

Now US banks are increasingly taking the next logical step -- they are selling or writing off all or part of their LDC exposure. A secondary market for LDC bank loans has thus emerged and developed as banks increasingly attempt to reduce or eliminate their exposure. While Secretary Baker, frustrated with "forced lending" fatigue, gave his official blessing for "the menu approach" to raising new money in the Spring of 1987, banks and investors have since shown more interest and ingenuity in enhancing the menu in reducing old debt. By participating in the Mexico-Morgan deal in the Winter of 1988, the US Treasury appears to have now followed the market, and placed "voluntary and market-oriented debt reduction" on Baker's evolving menu.

The collapsing secondary market prices of LDC loans since the middle of last year vividly capture the failure of the Baker Plan to restore creditworthiness in the problem debtor countries (Table 2). To be sure, these prices are generated in a thin -- although increasingly active -- market, and are perhaps unduly influenced by "the LDC debt bears." But they do reflect shifts in investor assessments of the quality of bank exposure to the LDCs, and the capacity of debtors to service their debts. Three developments are worth noting.

First, the discounts on LDC loans have risen sharply since the Citicorp loan-loss reserving in May 1987, and they have risen across the board.

Second, the bank debts of the top two LDC debtors -- Brazil

Table 2

Bid-Offer Prices for LDC Debt in the Secondary Market
(As a percentage of face value)

Country	Jul 1985	Feb 1987	Jun 1987	Oct 1987	Jul 1988	Change in offer price (percentage points) From Jul 1985 to Feb 1987	From Feb 87 to Jun 1987	From Jun 1987 to Jul 1988	July 1988 Creditworthiness Ranking
Colombia	81-83	86-89	85-88	75-80	60-65	6	-1	-23	1
Chile	65-69	66-69	68-70	50-53	57-60	0	1	-10	2
Venezuela	81-83	72-74	71-73	50-54	53-55	-9	-1	-18	3
Philippines	NA	72-76	70-72	57-60	50-53	NA	-4	-19	4
Mexico	80-82	57-59	57-59	46-49	50-52	-23	0	-7	4
Brazil	75-81	74-76	61-63	35-40	50-52	-5	-13	-11	4
Ecuador	65-70	62-65	51-54	31-34	23-27	-5	-11	-27	5
Argentina	60-65	62-65	50-53	34-38	32-35	0	-6	-34	6
Peru	45-50	16-19	14-17	2-7	5-8	-31	-2	-9	7

Note: Prices refer to those prevailing in the first week of the month.

Source: Shearson Lehman Asset Trading Inc

and Mexico -- are now selling at discounts of 50 percent, and the number three debtor -- Argentina -- is fetching no more than 25 cents on the dollar. While Mexican and Brazilian loans hit the bottom last October, selling below 50 cents on the dollar, Mexico's "reserves boom" and Brazil's return to the IMF and the banks for more new adjustment and more new money have caused only minor rallies in the value of their debts.

Finally, the secondary market prices of bank debts have fallen sharply, even for countries that are often touted as "success stories," with much of the decline taking place in the wake of Citicorp's loan-loss reserving. For example, the top two creditworthy debtor countries -- Columbia and Chile -- are fetching only around 60 cents on the dollar on their bank loans.

In short, the market is rejecting the official "market-oriented" debt strategy. Private investors, and increasingly creditor banks around the globe, are taking the position that most middle-income debtor countries cannot fully service their bank debts, and thus debt reduction and debt discounts are the way to go.

Some major banks argue that the true values of LDC loans are much higher than the secondary market prices, but instead of rushing to buy these cheap assets, they are increasingly using the secondary market to unload some of their own LDC claims. Since 1984, nine US money-center banks have reduced their loan exposure to the top four Latin debtors -- Brazil, Mexico, Argentina and Venezuela -- by almost $3 billion. The pace of LDC exposure reduction by the major US banks has accelerated recently: since June 1987, the thirteen largest US banks have

shed $6 billion of LDC loans, reducing their total developing country exposure by over 10 percent.

The market's menu of debt reduction, however, has its own defects as well. First, the market works in a marginal and uncoordinated fashion. While each successful dent on the old debt represents an individual bank's profit-maximizing (or, in this case, loss-minimizing) decision, in most cases, the debtor country sees only marginal -- and thus for all practical purposes, negligible -- reduction of the debt overhang. Moreover, with such an uncoordinated approach, the country remains uncertain as to the nature, the magnitude and the time of arrival of the next item on the evolving menu, and thus cannot adequately design, let alone implement, the much-encouraged growth-oriented structural reform within a medium-term framework.

In ther words, this marginalist, uncoordinated debt reduction approach prevents the country from capturing the systemic benefits of reduced debt service that would result from a more substantial, coordinated debt reduction. Consequently, while an individual bank pursues this approach in minimizing the default risk of its own exposure (in extreme cases, an individual bank can eliminate the default risk by selling off its total LDC exposure), the banking system as a whole also fails to capture the collective-action benefits of coordinated, large-scale reduction of debt.

Second, the market's menu fails to fully translate debt reduction into debt relief: part of the discount often escapes the debtor country and ends up in the hands of another foreign bank or a foreign multinational company. Again, if the full

benefit of debt reduction is not passed through to the debtor, it represents missed opportunities to use bank losses to achieve the maximum reduction of the country's "effective debt overhang" (future default risk).

Finally, several debt-reducing items on the market's menu create "macroeconomic indigestion" for the debtor country, if absorbed in large doses. For example, debt/equity swaps and local-currency conversions carried out on a large scale widen the participating country's budget deficit as the government repays or services dollar debts in local currency, which in turn leads to monetization, fueling further the rage of triple-digit inflation. This is largely why Mexico temporarily abandoned its debt/equity swap program in October 1987.

A New Approach: Coordinated Debt Reduction -- On a Case-by-Case Basis

The fatal flaws of the official "involuntary new money" plus "involuntary resource transfer" approach, and the failure of the market's menu approach to maximize the systemic welfare gains from incremental and uncoordinated debt reductions can be avoided by a voluntary, coordinated -- and case-by-case -- approach to debt restructuring and debt reduction. By explicitly recognizing that many of the middle-income countries do not have a "liquidity problem" which can be successfully treated with increased flow of new liquidity, but a "solvency problem" which has to be resolved with reduced stock of old liquidity, this approach can substantially ease the painful trade-off between forced borrowing and resource transfer for the countries, and between forced

lending and risk of default for the banks. With coordinated and large-scale debt reductions, it can also capture collective-action gains for the Third World and the creditor banks alike.

This case-by-case approach to coordinated debt reduction is based on a principle that is routinely used to restore financial health of insolvent domestic private companies. What I propose here is essentially a "debt workout" for foreign sovereign governments -- an international application of the Chapter 11 provision of the US bankruptcy code.

Here are some of the key building blocks of such an approach:

- The United States and Japan would create a debt facility which would act as a political mediator, financial intermediary and a debt guarantor. This "G-2 Facility" is politically and operationally more feasible than an administratively complex "International Debt Management Facility." Once in operation, this G-2 embryo can develop into a full-fledged multilateral facility as more debtor countries seek relief and more creditor countries seek membership.
- The Facility would be governed by a Board of Directors, with members chosen from the creditor governments involved, the IMF, the World Bank, the regional development banks, and perhaps two or three experts from the Third World with international reputation. It could draw on staff resources of the member multilateral institutions, and could operate from a single floor in one of the World Bank's nine buildings sprawled along Pennsylvania Avenue.

- The Facility would operate much the same way various IMF loan facilities work. When a middle-income debtor country decides it needs debt relief, it would submit to the Facility a "letter of intent," prepared in consultation with the Facility and the Fund/Bank staff, detailing a program for policy reform supported by debt service reduction. If the Board accepts the letter of intent (it can reject a plea for debt relief from a "misbehaving" country, thus discouraging pursuit of bad policies in order to seek relief), it would arrange negotiation with the creditor banks.
- The banks would exchange at par their floating-rate, longer-term, public-sector loans for bonds issued by the Facility with long maturities and fixed below-market rates. The spread between the market rate and the coupon rate will determine the implicit discount the banks will offer. Banks can hold these safe and marketable bonds, or sell them in a secondary market at implied discounts as they gradually mark down their exposure.
- The country would now service its restructured debts using the Facility as the intermediary. That is, the Facility would pass on the bank-losses as debt relief to the country in the form of reduced interest burden.
- The discount -- reduction in the interest bill and the resulting relief from resource transfer -- should be negotiated on the basis of the following two key criteria: (a) restoration of growth and investment consistent with efficient and high utilization of the

country's domestic resources; and (b) freeing private banks from the Ponzi trap of providing forced loans to finance their interest earnings.

- In exchange for receiving debt relief, the debtor country would implement the agreed-upon policy package and accept greater surveillance from the Facility. And in exchange for providing debt relief, the banks would receive regulatory and tax assistance to stretch out losses and replenish capital over time with the BIS ensuring internationally equitable treatment as the new capital guidelines are implemented.

This plan has a number of appealing features. First, taxpayers will not bail out the banks because banks will take losses as they replace risky loans with safe bonds. True, with the Facility guaranteeing the bonds, the G-2 governments will shoulder the much-reduced risk of the country's restructured obligations. But, the debt restructuring and policy reform package should be designed, implemented and monitored so as to ensure that the country has no incentive to default on its remaining debts. The reduced tax collection due to bank losses is not a bailout either: reduced debt burden will promote global growth and tax collection elsewhere (for example, in Corporate America, profiting from increased trade with the debtor LDCs), and more importantly, the alternative to a cooperative work-out will be confrontational defaults, with taxpayers forced to shoulder a much bigger bank bailout. So the plan will bail out the taxpayers, not the banks.

The Facility's capital requirements will be small. Even if

all fifteen Baker countries require relief averaging 40 percent on their long-term public sector bank debts, total disbursement for paid-in capital (say, 3 percent of total) will be around $450 million. If Japan provides a greater proportion (say, 80 percent) of the capital, the United States will have to disburse about $20 million per year over a five year period. With a $70 million annual obligation over the same period, this will be a cheap way for Japan to assume greater global responsibility and play a more effective leadership role in the design and implementation of policy reform in the developing countries within a multilateral framework. Aside from these minor capital costs, the modest operational costs of this "lean and mean" facility can be financed with small spreads from discounts on the loan/bond swap.

Second, the countries would receive immediate cashflow (resource transfer) relief while protecting themselves from future interest-rate hikes, and the banks would improve the quality of their exposure. Debt relief through the reduced interest burden of the low-coupon bonds would give a much bigger bang to the countries for the banks' lost buck than simple write-downs on principal, repayment of which has already been postponed for many years in most cases. This is so because countries need to maximize the reduction of resource transfer now (with minimum losses incurred by the banks), not in the twenty-first century. Also with fixed-rate, guaranteed obligations, the countries would get rid of interest-rate risk. The banks would manage (at least, temporarily) interest-rate risk -- a business they know, and eliminate the threat of sovereign default -- a risk they do not know how to manage.

Third, the plan will not risk the survival of banks with heavy LDC exposure. With beefed-up capital base and loan-loss reserves, these banks are now quite capable of absorbing major write-downs on their LDC exposure. Bank stock prices already reflect substantial anticipated write-downs on LDC loans -- the actual write-offs will only mark the banks' LDC exposure to market.

Fourth, the plan would avoid the much-feared "moral hazard" problem -- "bad behavior" of a debtor country would not be rewarded. To begin with, the Facility can reject debt relief for a country that pursues bad policies in order to get a bigger relief, thus discouraging misbehavior. And debt relief is given to a country that commits itself to policy reform. But more importantly, after relief is given, badly-needed new money from official sources to finance reform and development would remain conditional on carrying out those policy commitments. That is, while conditional debt relief would lighten the counterproductive burden of the debt overhang, it would tighten the room for "bad behavior" by policy strings attached to the flow of new money. Thus, this plan discourages the "moral hazard of debt relief" as it corrects the much-ignored "moral hazard of no debt relief" where the benefits of "good behavior" accrue to the creditors, not the debtors.

Fifth, this G-2 approach to developing a multilateral debt facility would avoid the establishment of yet another massive bureaucracy, and protect one or another of the existing institutions (the popular candidates are either the World Bank or the IMF) from taking on the full responsibility. The Facility

would act as "the visible hand," mediating between the private banks and the debtor countries, as well as combining and coordinating "the catalytic roles" of the multilateral agencies.

This "burden-sharing" approach is superior to other "go alone" approaches such as a World Bank guarantee on the new bonds or a debt facility within the IMF. A World Bank guarantee can seriously erode the Bank's credit standing at a time when its creditworthiness is already under critical scrutiny due to a rise in member country defaults and rapid expansion of policy-based (non-project) loans to troubled countries. An IMF facility is also likely to be counterproductive as the Fund, accustomed to short-term belt-tightening and balance-of-payments financing, will have internal difficulty in developing long-term, growth-oriented policy packages, and external difficulty in monitoring them in countries where it has little credibility and public support.

Sixth, the plan would permit private banks to completely withdraw from providing balance-of-payments loans to LDC governments. The much-encouraged recycling of Petrodollars to finance external deficits was responsible for the orgy of overlending and overborrowing of the seventies, and has prolonged the debt crisis as there exists no international Chapter 11 for settling bad debts of foreign governments. With banks fully weaned from balance-of-payments financing, the World Bank would step up structural and macroeconomic adjustment loans, the IMF would provide balance-of-payments loans to meet unforeseen needs and the private banks would limit themselves to providing trade credits and carefully-evaluated loans for low-risk projects.

Thus barricades against future debt crises would be set up as roadblocks to resolving the current crisis are removed.

Finally, just in case someone has not noticed, this plan represents a case-by-case, voluntary, flexible, market-oriented, cooperative and balanced approach to serve the community of enlightened self-interest. And it does not represent a generalized approach, wholesale solution, grand design, quick fix or panacea. It offers a pragmatic way out of counterproductive code words and cliches used to defend the bankrupt strategy of rescuing the insolvent countries.

Two possible criticisms of the plan merit response. First, it may be asked why the banks would come to the negotiating table to voluntarily write down loans on which they are currently receiving interest. One answer is that fatigued bankers, faced with continuing battles to recycle the interest bill and increasing threats of moratoria and defaults, may prefer a one-shot loss to disentangle themselves from the debt mess. But more importantly, once the official strategy of "forced lending" is abandoned, banks will come to the table for the same reason the debtor country will: with no new money, the country seeking relief will not be able to remain current on interest payments. Also, once the majority of the banks sign an agreement, new legislative measures can force the dissenters -- the so-called free riders -- to join. This legal recourse is already permitted in domestic settlements by US bankruptcy laws.

Second, many argue that debt relief will hurt the middle-income countries by inflicting long-term damage to their creditworthiness. This is a red herring. To begin with, the

creditworthiness of these countries has already suffered badly, and the current strategy is damaging it further. Policy reform supported by debt relief is much more likely to restore creditworthiness by promoting growth, investment and business confidence. The improved economic environment can lure back domestic capital that fled abroad to seek safe haven -- often in the high-yielding accounts of the creditor banks themselves -- and attract foreign capital seeking opportunities for profitable investment. Those who worry about debt relief damaging creditworthiness appear to have "confrontational repudiation" in mind, not "cooperative restructuring" that is routinely used for restoring creditworthiness of insolvent debtors within the United States under the Chapter 11 provision of the US bankruptcy code.

Debt, Democracy and Leadership

The proposed "G-2 Facility" should not be interpreted as a definitive solution to the debt crisis, but a pragmatic framework to be modified, refined, and further developed through constructive debate and dialogue. If the major creditor governments prefer to avoid such a dialogue in the short-sighted hope that the debt problem will simply disappear in the ever-expanding maze of the market's menu, then this proposal can at least be filed away as one of many ideas to draw upon, should a confrontational crisis suddenly erupt, and panic-stricken authorities find themselves scrambling to put together a rescue plan in haste.

While the economic-financial-regulatory aspects of a case-by-case approach to cooperative debt restructuring must be

worked out with great care, it is politics that will ultimately determine the success of such an approach. The debt crisis is a phenomenon of "market failure": we have a crisis because the market failed, and we would have a bigger crisis if the market tried to resolve it on its own. And that is why politics is crucial: a cooperative approach -- however market-oriented -- cannot succeed without political leadership. This leadership must come from both sides of the debt divide -- the debtor governments seeking relief, and the creditor governments catalyzing it.

No amount of debt relief and financial engineering will restore growth and creditworthiness in a debtor country unless its government can provide the political leadership to develop the necessary policy package with mediation from the Facility, implement it rigorously, and garner public support to sustain it. While debt relief can be brought from abroad and play a "catalytic role" in generating domestic support for structural adjustment, policy reform has to be home-grown. People have to support the government's program, not because the IMF wants it (in fact, that path will surely lead to failure), but because they will see it is to their long-term self-interest.

No less important is political leadership in the major creditor countries -- in particular, in Washington. The United States must provide the necessary leadership in supporting and implementing a cooperative, case-by-case approach based on policy reform supported by debt relief. Without US leadership and support, such an approach cannot emerge, let alone develop. But more importantly, leadership breeds leadership. Correct signals from Washington can encourage the other major creditor

governments -- in particular, Japan -- to come forth with new ideas and new money. Moreover, visionary leadership in Washington can catalyze courageous leadership in Brasilia, Mexico City and Buenos Aires.

The alternative is to continue to muddle through. But that will be an increasingly costly strategy of "voodoo economics" guided by "ostrich politics." Social and political costs of the current debt strategy have already begun to take their toll in Latin America. Even with large-scale fraud, the ruling party in Mexico barely won the recent election, and faces strong opposition to pursuing more austerity to protect profits of foreign banks. The debt crisis has polarized Brazil with next year's election likely to bring either the left or the right into power. In Argentina, the ruling party is also paying the price of the current debt strategy: the populist wing of the Peronist party is closing in to win next year's election with the pledge of a five-year moratorium on the nation's foreign debt. The US foreign policy costs of sticking with the current strategy can be disastrously high as the debt overhang increasingly threatens democracy in Latin America and the Caribbean with nineteen changes in governments scheduled by the end of next year.

We are also in the middle of changing administration here in this country. But time is running out fast in the nations to the south of our border. If the new administration wishes to promote political stability and protect democratic institutions in Latin America, it needs to act sensibly, and act fast. But if it chooses to continue to muddle through between debt and democracy, the consequence could be confrontational defaults, global

economic instability and resurgence of dictatorships -- in Latin America and other parts of the Third World.

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CRS REPORT FOR CONGRESS

U.S. BANK EXPOSURE IN THE SEVENTEEN HIGHLY INDEBTED COUNTRIES: 1982 - 1987

U.S. bank exposure in the seventeen most highly indebted countries has fallen by 10 percent since the onset of the international debt crisis in 1982. Exposure has also fallen relative to capital and assets. Despite the improved position of the U.S. banking system as a whole, however, the nine money center banks continue to be at substantial risk. Moreover, the increased concentration of debt in the public sector of the 17 countries implies increased vulnerability to sovereign borrowers.

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July 27, 1988

U.S. BANK EXPOSURE IN THE SEVENTEEN HIGHLY INDEBTED COUNTRIES: 1982 - 1987

SUMMARY

Total exposure of U.S. banks in the 17 highly indebted countries has dropped significantly since the onset of the debt crisis in 1982 -- by 10.5 percent. Most of this decline is attributable to a decrease in the level of exposure of the non-money center banks. The non-money center banks have also substantially decreased their exposure relative to capital and assets. It would appear that the financial exposure of the non-money center banks in these countries is now at a manageable level in the event of default or interruption of debt service.

The nine money center banks have also experienced an improvement in their position vis-a-vis the 17 troubled debtor nations even though their total exposure has declined only slightly. Their ratio of exposure to capital has dropped dramatically, but not enough to bring it within a range which might be considered manageable. Their exposure relative to assets has improved only slightly. Thus, the nine money center banks, unlike the non-money center banks, remain substantially at risk to any financial difficulties encountered by these 17 countries. Finally, the decreased financial exposure of U.S. banks as a whole in the 17 highly indebted countries may be more than offset by an increased vulnerability to sovereign risk. This results from the increased holdings of public sector debt of the 17 troubled borrowers now held by the U.S. banking system.

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U.S. BANK EXPOSURE IN THE SEVENTEEN HIGHLY INDEBTED COUNTRIES: 1982 - 1987

Since the onset of the international debt crisis in August 1982, U.S. bank exposure in the troubled borrowers of the Third World has been of concern to many, including policy-makers, regulators, and the U.S. Congress. This report provides basic data on the exposure of U.S. banks to the 17 most highly indebted countries (HICs) as defined by the World Bank.[1] Twelve of the 17 highly indebted countries are in Latin America: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Jamaica, Mexico, Peru, Uruguay, and Venezuela. The remaining five countries are the Ivory Coast, Morocco, Nigeria, Philippines, and Yugoslavia. Of the 17 countries only Costa Rica and Jamaica have not been participants in the "Baker Plan," that is, the current U.S. program or strategy for solving the international debt problem.[2] Finally, this report updates and supersedes CRS Report No. 87-299 E, U.S. Bank Exposure in the 'Baker Plan' Fifteen Countries.

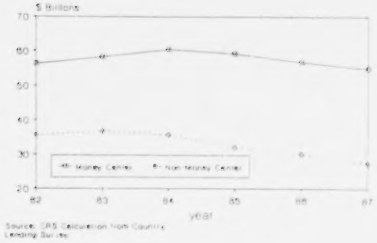
U.S. BANK EXPOSURE

At the end of 1982, U.S. bank exposure in the 17 highly indebted countries, as illustrated in chart 1, was $91.8 billion.[3] Bank exposure rose dramatically in 1983 and 1984 as the banks provided additional liquidity to their floundering borrowers. Thus, U.S. bank exposure peaked in 1984 at $96.2 billion, an increase of 4.8 percent from the 1982 level. Virtually all of this lending was "forced" lending, that is, lending undertaken as part of a borrower "bailout."

In 1985 U.S. bank exposure dropped to levels which were slightly below 1982 levels, thereby beginning a lending cutback which has continued without interruption. Thus, by the end of 1987, outstanding loans had declined a full 10.5 percent below their 1982 level -- to $82.2 billion. This decrease in exposure highlights the difficulty of getting new financial resources to the debtor countries, a central feature of the debt strategy since 1982. It also means that U.S. banks are also somewhat less vulnerable to the financial difficulties of their troubled Third World borrowers.

CHART 1

Exposure of U.S. Banks
in 17 Highly Indebted Countries,
1982-1987



Source: CRS Calculation from Country Lending Surveys

RELATIVE EXPOSURE OF MONEY CENTER AND NON-MONEY CENTER BANKS

Chart 1 also shows the portions of total U.S. bank exposure held by the nine money center banks[4] and by the non-money center banks, that is, all other U.S. banks.[5] While the debt held by the 9 money center banks in the 17 countries as a group peaked in 1984 at $60.5 billion, the holdings of all other U.S. banks peaked a year earlier, in 1983, at $36.7 billion. Since then the relative shares of holdings of the two groups of banks have declined at dramatically different rates. Money center bank exposure in the 17 countries was $54.9 billion at the end of 1987, just 2.6 percent below their exposure in 1982. By comparison, holdings of the non-money center banks have dropped from $35.5 billion to $27.3 billion, a decrease of 23.1 percent. Thus, most of the decline (85.0 percent) in total U.S. bank exposure in the 17 highly indebted countries is attributable to a decline in the amount of outstanding debt held by the non-money center banks. By 1987,

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[1] The various groupings of countries which report their external debt status to the World Bank (International Bank for Reconstruction and Development (IBRD)) under its Debtor Reporting System are listed in World Bank. World Debt Tables. Vol. I, 1987-1988 ed., p. xlvii - xlix.

[2] For details on the Baker Plan, see U.S. Library of Congress. Congressional Research Service. The "Baker Plan": A Remedy for the International Debt Crisis? Issue Brief No. IB86106, by Patricia Wertman. Washington, 1986. (Updated regularly.)

[3] Detailed data on U.S. bank exposure in the 17 countries are provided in Appendix table 1.

[4] The nine money center banks include Bank America Corp., Continental Illinois Corp., First Chicago Corp., CitiCorp, Chase Manhattan Corp., Manufacturers Hanover Corp., J.P. Morgan & Company, Bankers Trust New York Corp., and Chemical New York Corp.

[5] Detailed data on the exposure of the nine money center banks and on the exposure of the non-money center banks in the 17 countries are provided in Appendix tables 2 and 3.

Senator SARBANES. Thank you. We thank all of the panel for very effective presentations and we also thank you for these very carefully worked out full statements that have been submitted and which will be included in the record.

I'm going to ask a few questions and then I'm going to have to turn the hearing over to Senator Graham because I'm already quite late for another engagement.

I want to ask about the bad actors and the free riders in any scheme that you work out to try to deal with this. First of all, the bad actors. Assuming that the banks take a hit on the discount, if you gear the discount to the secondary market, the worst actors have the biggest discounts. So in a sense, the countries that have struggled the most to stay abreast and everything would have a lesser discount and end up getting less relief, if you use that as the standard. If you don't use that as the standard, then what do you use as a standard and doesn't it become highly political, potentially highly confrontational in a political context?

Now, Professor Fishlow, I think you said, well, let's look ahead and not behind, and that's all right; but I'm not sure how completely you can do that. So if you all would address the bad actor problem first in any scheme that we try to come forward with.

BAD ACTORS

Mr. FISHLOW. The notion of moral hazard carries with it the implication that somebody has deliberately taken an action with an expectation that they can rig the outcome.

In the case of a country whose debt is now selling at 20 cents, they would have had it selling at a dollar if they could have. The reason why the discount is as large as it is, is not primarily because of the actions of the country itself, but external circumstances. Terms of trade, for example, have affected many of the debtor countries. They are beyond their control. And second, internal policy had to be devised within an environment in which there was no new lending to support appropriate policies.

So I think we have to be careful about applying the notion that countries have deliberately gotten into this bind.

The second aspect is that debt reduction is not a real reward or penalty. You're not telling another country that they're going to be paying more than they possibly could out of their resources as a result of allowing them less relief than, say, a Peru. Its debt now on the secondary market is close to worthless for the reason that no one can perceive, given its income per capita fallen to a level that it had in the 1960's, that's going to be able to service that debt. So for all practical purposes, it really is worthless. That is a market result, not a reward.

We see bad performance, but we have to differentiate that from the bad actor problem.

The second point that I would make is that you don't have to use the market discount to determine the extent of relief. What you should be using is some assessment of the future oriented capacity to pay consistent with an adjustment program that gets established.

What the secondary market is telling us is that the debt is worthless in the present policy framework. It doesn't tell us what Peru could reasonably pay over the next 20 years. If Peru were growing, it could pay some reasonable proportion of its exports and its income. A conditional contract that said if Peru were successful in recovering, it would have to pay a particular percentage of its income, could help to provide an incentive to establish an adjustment program and to pay what it could. The return from that performance would be shared. Everyone gains from looking forward and emphasizing better results.

We ought to avoid the red herring of past poor performance calling a moral hazard problem as though somehow this was a conscious decision on the part of the country. Rather, I think we have to see it as a symptom of the failure of the debt strategy.

Senator SARBANES. If you took Mr. Nicholson's approach and dealt with the interest stream rather than the principal, if one doesn't accept your conclusion that there's not something of a problem coming to terms with this just perhaps even in a political sense, that that would reduce the nature of the problem, would it not?

Mr. FISHLOW. If we gave interest relief rather than principal relief?

Senator SARBANES. Yes.

Mr. FISHLOW. No, because the two really come out to be identical, as I suggested earlier. A case-by-case approach requires that we understand whether or not we ought to put the benefits up front, say, in terms of immediate cash flow or whether in the case of some countries the situation is so dismal that one just ought to go and take a very substantial reduction in principal, and therefore, also cash flow.

Conceptually, an equivalent amount of debt relief, or debt reduction, can be applied by reducing interest payments or principal or their combination. The question is how we time the relief rather than its magnitude. For many countries, the immediate cash flow would be a more important element in being able to stimulate economic activity. I would imagine that a facility, when it was designing adjustment programs, would then opt for that sort of approach.

Senator SARBANES. But if you did it on the interest side, you would have to develop a standard. There's no existing standard. Is that correct?

Mr. FISHLOW. No, there is no existing standard.

Senator SARBANES. There is an existing standard on discounting the principal, is there not?

Mr. FISHLOW. Well, it's a dubious standard. It's a dubious standard because I think the secondary market is a very thin market. It probably is prone to pessimism at the moment about the situation of debtor countries, not surprisingly, because of the inactivity of the U.S. policy; and, therefore, it does not accurately reflect what countries reasonably might be expected to pay.

Senator SARBANES. Well, I just think if you're trying to work this out and, one, you're already within a framework that defines certain things—maybe you can depart from them, but there is a definition. In the other you're not in a framework that's defined.

Mr. FISHLOW. Well, the amount of interest or principal relief that you would give would be determined in the same fashion. If you want to use a market discount as a relevant measure that would also tell you how much interest you could reduce. More interest reduction now would be matched by larger principal payments later to make the total present value of the payments exactly equal to a once-for-all reduction of principal.

Senator SARBANES. OK.

Mr. FISHLOW. So both are equivalent in that respect.

Senator SARBANES. Let me ask about the free rider. I want the others to participate, first of all, if they want to add something on the bad actor, but on the free rider, how do you address the problem if your approach is voluntary, which everyone sort of puts up front now. No one is saying we're going to mandate or compel this. If it is voluntary, how do you address those who say: "Well, I'll play this system and I'll hang back and let the others go in and my position in the end will be strengthened as a consequence of what they've done but I've made no sacrifice in order to achieve that."

FREE RIDER

Mr. DORNBUSCH. Can I add something to the previous discussion? I think Mr. Fishlow has rightly said that the bad actor issue is vastly overrated. I would also add that the secondary market discounts are very tightly related to how much interest is being paid. So in fact it's not totally one-for-one, but it's quite close. And the discount can be a guide for you on the interest payments that effectively are being made and can be a guide for you.

I think he's very much right to say that you don't want to start with a lot of writing off. You want to start restructuring the debt with conditional payments based on a country's future performance.

Now on the free rider issue, I think the countries collaborating with the facility would be well placed to say that they pay free riders only after they have exhausted every other possible use of their resources and that effectively looks after that. And if this is recognized as a reasonable policy, the free rider problem has basically disappeared.

Senator SARBANES. OK. Thank you very much.

Senator Graham.

Mr. ISLAM. May I add a little bit on the bad actors?

Senator SARBANES. Yes, if you could briefly.

Mr. ISLAM. Quickly, I would say in the moral hazard of the bad actor there are really three things one should think about. Bad behavior before relief, bad behavior in terms of how much relief they get, and bad behavior after relief. I would say that if you have the facility with the capacity to reject a letter of intent by a badly behaving country, then the incentive to behave badly will not be there. So the ability to reject a letter of intent will ensure that.

The amount of relief you get, as I said in my statement, should be really determined not so much by the secondary market discount or anything else, but by the criteria that the interest reduction should be enough to promote growth and investment in this country, and to ensure that the private banks will not have to put

up new money to finance their own interest earnings. Those should be the criteria to be used and not bad behavior. And after relief, as I said, it could be conditional on new official money—the IMF and the World Bank will still provide money to those countries and if those countries don't perform those moneys will not be coming forth.

I want to make one more point: The present strategy has a bigger moral hazard problem—bad actor problem—than the debt relief approach because right now the incentive for countries is to badly behave because if they behave well the benefits go to the banks, it doesn't come to them.

So I would say that after the relief, good behavior will benefit the countries themselves. The incentive pattern is actually perverse now and will be corrected later. You said that Mr. Botero said it is remarkable that these countries have continued to behave quite well. If they have behaved so well under such bad incentives, I would think they would behave even better under a more positive incentive.

Senator SARBANES. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I'm intrigued by that last comment in the reverse side, and that is in the context of a country which has performed positively during this period such as Venezuela.

They ask the question:

> We have accounted for about 30 to 40 percent of the principal repayment which has occurred among Latin American countries in the last 5 or 6 years and yet we are not receiving any positive benefits from our performance in terms of specifically access to additional investment, either equity or lending.

VENEZUELAN COMPLAINT

Is that a legitimate complaint of the Venezuelans? And if it is, why is the current incentive structure not positively rewarding their good performance?

Mr. FISHLOW. Well, in part, I think the Venezuelan problem has been that their performance on repayment of debt has been better than their economic performance. If one looks at the record in terms of Venezuelan growth, it has really been quite dismal over this period of time. Part of the internal debate—and there's a presidential election that's underway in Venezuela at the moment—has precisely to do with whether or not the reserves of the country were well used in paying back principal versus importing capital goods that might have stimulated a higher rate of growth.

The fact that additional lending is not available to Venezuela reinforces a fundamental point that is central to the failure of the Baker plan strategy. The capital market that began to develop in the 1970's on the basis of commercial bank lending was not a permanent phenomenon. Commercial banks were not in the business of making available long-term resources for development or even for balance-of-payment assistance.

In those circumstances, the fact that Venezuela pays back the bank gives no inducement to the bank to increase its exposure. It makes the bank very happy. It certainly makes the shareholders of the bank even happier. And that's where the story ends. That's exactly why one can't depend upon a resumption of lending in a gen-

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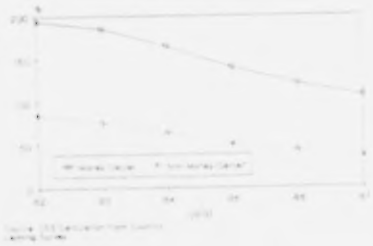
the non-money center banks accounted for about one-third of total U.S. bank exposure to these countries -- down from the nearly 39 percent share which they held in 1982. It should be noted that these data are consistent with widespread reports that regional and smaller U.S. banks have been aggressively selling and/or writing-off their Third World exposure.

U.S. BANK EXPOSURE RELATIVE TO CAPITAL

In the event of default, a bank's first and most important protection against its own financial failure is its capital.[6] The exposure of both money center and non-money center banks relative to capital has declined continuously since 1982, as illustrated in chart 2 below. The exposure of the money center banks as a group declined dramatically from the 1982 level of 192.4 percent, but, nevertheless, remained uncomfortably high at 106.6 percent in 1987. By comparison, the exposure of the non-money center banks as a group declined from 85.5 percent in 1982 to 35.2 percent in 1987, a manageable level.

CHART 2

Exposure of U.S. Banks in 17 Highly Indebted Countries as a Percentage of Capital 1982-1987



Much of the shift in the ratio of bank exposure to capital can be attributed to declining exposure as discussed above. An even greater amount of this shift can, however, be attributed to increasing capital. The capital of the money center banks rose from $29.0 billion in 1982 to $51.5 billion in 1987, an increase of 77.6 percent. The capital of the non-money center banks rose even more dramatically, from $41.6 billion in 1982 to $77.7 billion in 1987, an increase of 86.8 percent.

[6] Bank capital includes equity, subordinated debentures, and reserves for loan losses. Data on the level of capital and the ratio of exposure to capital for the money center and non-money center banks are contained in Appendix at the end of tables 2 and 3.

U.S. BANK EXPOSURE RELATIVE TO ASSETS

Another way of examining U.S. banks' vulnerability to default is to consider the ratio of a particular category of assets (loans) to their total assets.[7] Thus, the greater the percentage of assets outstanding to the 17 highly indebted countries the greater is the banks' vulnerability to default or debt service interruption. The exposure of U.S. banks in the 17 highly indebted countries as a group relative to assets is illustrated below in chart 3.

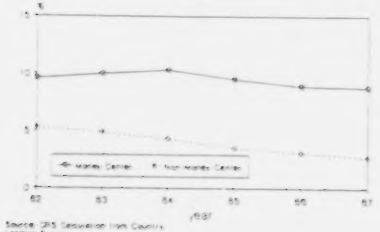
The vulnerability of the U.S. banking system as a whole has not changed greatly between 1982 and 1987. Exposure in the 17 highly indebted countries as a percentage of assets for the U.S. banking system as a whole has shifted slightly downward, from 7.1 percent to 5.0 percent.[8] Once again, however, the non-money center banks have been more successful at decreasing their relative vulnerability. While cutting their exposure the non-money center banks have also dramatically increased their assets, from $673 billion in 1982 to $1.0 trillion in 1987, an increase of almost 50 percent. As a result the ratio of exposure in the 17 HICs to assets for non-money center banks has been nearly halved. Meanwhile the same ratio for the money center banks dropped only from 9.6 percent in 1982 to 8.8 percent in 1987. Their assets have grown at a much slower rate, from $588 billion to $628 billion, an increase of 6.5 percent.

[7] Data on the level of assets and the ratio of exposure to assets for the money center and non-money center banks are contained in Appendix at the end of tables 2 and 3.

[8] Calculated from Appendix tables 2 and 3.

CHART 3

Exposure of U.S. Banks in 17 Highly Indebted Countries as a Percentage of Assets, 1982-1987



Source: CRS Calculation from Country Lending Survey

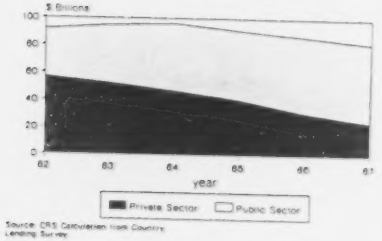
SECTORAL DISTRIBUTION OF U.S. BANK EXPOSURE

Chart 4 illustrates the division of U.S. bank exposure between the public and private sectors in the 17 debtor countries.[9] Between 1982 and 1987 the relative shares of debt owed by the public and private sectors in the borrowing countries have reversed. In 1982 close to two-thirds of all debt owed by the 17 HICs was owed by the private sector; by 1987, somewhat over two-thirds of the total debt was owed by the public sector. There may be a number of factors which account for this shift, including the consolidation of private sector debt into public sector debt in some countries, greater write-offs or sell-offs of private sector debt, and, possibly, greater difficulty of the private sector in obtaining new loans. In any case, the exposure of U.S. banks to the private sector in these 17 countries has declined from $57.2 billion to $24.8 billion, a decrease of 56.6 percent. Simultaneously, exposure to the public sector in the 17 HICs has risen from $34.6 to $57.4 billion, an increase of 65.9 percent. Clearly, U.S. banks are now more vulnerable to sovereign government default, potentially as much a political decision on the part of the borrowers as an economic decision.

[9] Detailed data on the breakdown of U.S. bank exposure between the public and private sectors in the 17 countries are provided in Appendix table 1.

CHART 4.

Debt Owed To U.S. Banks by Public & Private Sectors, 17 Highly Indebted Countries, 1982-1987



Source: CRS Calculation from Country Lending Survey

CONCLUSION

The position of U.S. banks with regard to the 17 most highly indebted developing countries has improved since the onset of the international debt crisis in August 1982. Exposure levels, both absolutely and relatively, have declined. In particular, the exposure of the non-money center banks now appears to be manageable. The nine money center banks, however, continue to be at considerable risk. The increasing concentration of the external debt of the 17 highly indebted countries in the public sector increases the vulnerability of all U.S. banks to the risks of default or debt service interruption by sovereign borrowers.

APPENDIX

TABLE 1. U.S. Bank Exposure in the 17 Highly Indebted Countries, All Banks, Public and Private Sector Exposure 1982-1987 ($ millions)

COUNTRY	1982	1983	1984	1985	1986	1987
ARGENTINA						
Public Sector	3,067.8	3,596.3	4,041.1	4,957.8	5,638.0	6,384.0
Private Sector	5,163.1	4,907.5	3,933.6	3,452.8	2,886.0	2,427.0
Total	8,230.9	8,503.8	7,974.7	8,410.6	8,524.0	8,811.0
BOLIVIA						
Public Sector	247.9	228.0	167.5	84.2	75.0	52.0
Private Sector	129.2	86.1	44.8	28.4	21.0	15.0
Total	377.1	314.1	212.3	112.6	96.0	67.0
BRAZIL						
Public Sector	7,295.6	8,250.2	11,918.2	12,211.2	13,998.0	14,151.0
Private Sector	13,141.9	12,402.3	11,950.2	10,584.4	8,412.0	7,126.0
Total	20,437.5	20,652.5	23,868.4	22,795.6	22,410.0	21,277.0
CHILE						
Public Sector	1,076.9	1,753.9	2,629.9	3,111.4	3,947.0	4,133.0
Private Sector	5,003.5	4,446.4	4,067.3	3,457.6	2,515.0	1,864.0
Total	6,080.4	6,200.3	6,697.2	6,569.0	6,462.0	5,997.0
COLOMBIA						
Public Sector	1,011.0	1,051.4	1,138.9	1,255.1	1,204.0	1,156.0
Private Sector	2,184.6	2,264.8	1,827.6	1,370.1	944.0	912.0
Total	3,195.6	3,316.2	2,966.5	2,652.2	2,148.0	2,068.0
ECUADOR						
Public Sector	756.7	1,238.3	1,728.6	1,939.3	1,873.0	1,797.0
Private Sector	1,272.3	847.8	415.2	203.2	297.0	123.0
Total	2,029.0	2,086.1	2,143.8	2,142.6	2,170.0	1,920.0
IVORY COAST						
Public Sector	496.2	451.9	394.3	318.9	291.0	321.0
Private Sector	148.0	93.5	76.2	38.8	74.0	43.0
Total	644.2	545.4	470.5	357.7	365.0	364.0
MEXICO						
Public Sector	9,696.9	12,007.8	13,502.9	13,364.5	14,531.0	15,602.0
Private Sector	14,679.8	14,329.7	13,022.0	11,569.7	9,125.0	7,120.0
Total	24,376.7	26,337.5	26,524.9	24,934.2	23,656.0	22,722.0
MOROCCO						
Public Sector	368.8	338.5	380.4	415.0	470.0	520.0
Private Sector	387.7	572.0	530.6	489.7	422.0	299.0
Total	756.5	910.5	911.0	904.7	892.0	819.0
NIGERIA						
Public Sector	897.7	1,553.2	1,227.6	762.4	548.0	678.0
Private Sector	956.2	513.2	311.1	436.1	355.0	223.0
Total	1,853.9	2,066.4	1,538.7	1,198.5	903.0	901.0

(continued)

TABLE 1. U.S. Bank Exposure in the 17 Highly Indebted Countries, All Banks, Public and Private Sector Exposure -- continued 1982-1987 ($ millions)

COUNTRY	1982	1983	1984	1985	1986	1987
PERU						
Public Sector	915.6	1,609.9	1,590.3	1,149.7	894.0	686.0
Private Sector	1,625.3	885.3	766.6	504.5	452.0	217.0
Total	2,540.9	2,495.2	2,356.9	1,654.2	1,346.0	903.0
PHILIPPINES						
Public Sector	2,444.6	2,795.0	2,443.4	3,316.8	3,553.0	3,146.0
Private Sector	3,300.9	3,266.4	3,010.2	2,101.4	1,554.0	1,529.0
Total	5,745.5	6,061.4	5,453.6	5,418.2	5,107.0	4,675.0
URUGUAY						
Public Sector	639.4	835.1	890.9	796.6	815.0	836.0
Private Sector	280.8	213.8	172.6	116.0	114.0	104.0
Total	920.2	1,048.9	1,063.5	912.6	929.0	940.0
VENEZUELA						
Public Sector	4,841.5	5,346.1	5,374.6	5,125.2	5,561.0	5,908.0
Private Sector	6,733.8	5,911.0	5,438.0	4,965.2	3,552.0	2,415.0
Total	11,575.3	11,257.1	10,812.6	10,090.4	9,113.0	8,323.0
YUGOSLAVIA						
Public Sector	393.5	655.8	961.6	1,024.4	1,378.0	1,571.0
Private Sector	1,926.0	1,776.2	1,417.7	1,373.7	688.0	343.0
Total	2,319.5	2,432.0	2,379.3	2,398.1	2,066.0	1,914.0
"BAKER PLAN" 15						
Public Sector	34,150.1	41,711.4	48,390.2	49,832.5	54,776.0	56,941.0
Private Sector	56,933.1	52,516.0	46,983.7	40,691.6	31,411.0	24,760.0
Total	91,083.2	94,227.4	95,373.9	90,524.2	86,187.0	81,701.0
COSTA RICA						
Public Sector	262.9	321.3	380.2	383.2	373.0	303.0
Private Sector	234.7	174.7	83.4	67.5	43.0	33.0
Total	497.6	496.0	463.6	450.7	416.0	336.0
JAMAICA						
Public Sector	190.7	249.9	320.1	257.0	182.0	139.0
Private Sector	71.5	58.7	9.2	3.7	22.0	22.0
Total	262.2	308.6	329.5	260.7	204.0	161.0
TOTAL DEBT	91,843.0	95,032.0	96,167.0	91,235.6	86,807.0	82,198.0
Public Sector	34,603.7	42,282.6	49,090.7	50,472.7	55,331.0	57,383.0
Public Sector as a Percent of Total	37.7%	44.5%	51.0%	55.3%	63.7%	69.8%
Private Sector	57,239.3	52,749.4	47,076.3	40,762.8	31,476.0	24,815.0
Private Sector as a Percent of Total	62.3%	55.5%	49.0%	44.7%	36.3%	30.2%

Note: Totals do not necessarily add due to rounding.

Source: Prepared by the Congressional Research Service from Federal Financial Institutions Examination Council, Statistical Release E. 16(126), Country Exposure Lending Survey. Various Years.

TABLE 2. U.S. Bank Exposure in the 17 Highly Indebted Countries
Nine Money Center Banks - 1982 to 1987
($ millions)

COUNTRY	1982	1983	1984	1985	1986	1987
ARGENTINA						
Exposure	5,125.2	5,353.8	5,106.1	5,874.7	5,927.0	6,295.0
% of Capital	17.7%	17.0%	13.3%	13.9%	12.1%	12.2%
% of Assets	0.9%	0.9%	0.9%	0.9%	0.9%	1.0%
BOLIVIA						
Exposure	230.2	199.4	119.4	58.6	44.0	39.0
% of Capital	0.8%	0.6%	0.3%	0.1%	0.1%	0.1%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
BRAZIL						
Exposure	13,296.2	13,298.4	15,800.2	15,550.1	15,358.0	15,007.0
% of Capital	45.8%	42.2%	41.1%	36.8%	32.9%	29.1%
% of Assets	2.3%	2.3%	2.7%	2.5%	2.4%	2.4%
CHILE						
Exposure	3,326.1	3,438.5	3,823.9	4,067.1	4,146.0	4,008.0
% of Capital	11.5%	10.9%	10.4%	9.6%	8.9%	7.8%
% of Assets	0.6%	0.6%	0.6%	0.7%	0.6%	0.6%
COLOMBIA						
Exposure	2,225.4	2,240.3	2,181.3	1,923.8	1,328.0	1,389.0
% of Capital	7.7%	7.1%	5.6%	4.5%	3.1%	2.7%
% of Assets	0.4%	0.4%	0.4%	0.3%	0.2%	0.2%
ECUADOR						
Exposure	1,152.4	1,228.7	1,335.0	1,365.1	1,358.0	1,242.0
% of Capital	4.0%	3.9%	3.6%	3.2%	2.9%	2.4%
% of Assets	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
IVORY COAST						
Exposure	491.2	403.9	333.0	292.5	274.0	302.0
% of Capital	1.7%	1.3%	0.9%	0.6%	0.6%	0.6%
% of Assets	0.1%	0.1%	0.1%	0.0%	0.0%	0.0%
MEXICO						
Exposure	12,861.6	14,137.1	14,693.3	14,667.1	13,353.0	13,351.0
% of Capital	44.4%	44.8%	40.8%	33.1%	28.6%	25.9%
% of Assets	2.2%	2.4%	2.5%	2.3%	2.1%	2.1%
MOROCCO						
Exposure	588.9	764.2	712.6	657.4	687.0	676.0
% of Capital	2.0%	2.4%	1.9%	1.6%	1.5%	1.3%
% of Assets	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
NIGERIA						
Exposure	1,448.4	1,531.7	1,146.5	903.4	667.0	730.0
% of Capital	0.5%	4.9%	3.1%	2.1%	1.4%	1.4%
% of Assets	0.2%	0.3%	0.2%	0.1%	0.1%	0.1%
PERU						
Exposure	1,364.2	1,352.9	1,295.3	936.3	818.0	485.0
% of Capital	4.7%	4.3%	3.5%	2.3%	1.8%	0.9%
% of Assets	0.2%	0.2%	0.2%	0.2%	0.1%	0.1%

(continued)

TABLE 2. U.S. Bank Exposure in the 17 Highly Indebted Countries
Nine Money Center Banks - 1982 to 1987 -- continued
($ millions)

COUNTRY	1982	1983	1984	1985	1986	1987
PHILIPPINES						
Exposure	3,881.6	3,930.7	3,756.1	3,390.8	3,703.0	3,275.0
% of Capital	13.4%	12.5%	10.2%	9.0%	7.9%	6.4%
% of Assets	0.7%	0.7%	0.6%	0.6%	0.6%	0.5%
URUGUAY						
Exposure	611.8	767.9	789.1	713.5	698.0	697.0
% of Capital	2.1%	2.4%	2.2%	1.7%	1.5%	1.4%
% of Assets	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
VENEZUELA						
Exposure	7,803.9	7,635.7	7,435.1	,127.6	6,507.0	5,823.0
% of Capital	26.9%	24.2%	20.3%	16.9%	13.9%	11.3%
% of Assets	1.3%	1.3%	1.3%	1.1%	1.0%	0.9%
YUGOSLAVIA						
Exposure	1,460.8	1,556.7	1,502.6	1,522.2	1,315.0	1,248.0
% of Capital	5.0%	4.9%	4.1%	3.6%	2.8%	2.4%
% of Assets	0.2%	0.3%	0.3%	0.2%	0.2%	0.2%
"BAKER PLAN" 15						
Exposure	55,868.3	57,829.9	60,029.5	58,850.5	56,381.0	54,566.0
% of Capital	92.6%	183.6%	163.6%	139.1%	120.1%	106.0%
% of Assets	9.5%	9.9%	10.2%	9.4%	8.8%	8.7%
COSTA RICA						
Exposure	231.7	234.3	224.5	219.7	214.0	180.0
% of Capital	0.8%	0.7%	0.6%	0.5%	0.5%	0.3%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
JAMAICA						
Exposure	224.6	252.5	246.9	210.3	171.0	131.0
% of Capital	0.8%	0.8%	0.7%	0.5%	0.4%	0.3%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
TOTAL						
Exposure	56,324.6	58,316.7	60,500.9	59,280.5	56,768.0	54,877.0
% of Capital	94.2%	185.1%	164.9%	140.1%	121.0%	106.6%
% of Assets	9.6%	10.0%	10.3%	9.5%	8.9%	8.8%
MEMORANDA:						
Capital:	29,000.0	31,500.0	36,700.0	42,300.0	46,700.0	51,500.0
Assets:	588,000.0	582,000.0	589,000.0	673,000.0	638,000.0	626,000.0

Note: Totals do not necessarily add due to rounding.

Source: Prepared by the Congressional Research Service from Federal Financial Institutions Examination Council, Statistical Release E.16(126), Country Exposure Lending Survey. Various Years.

TABLE 3. U.S. Bank Exposure in the 17 Highly Indebted Countries
Non-Money Center Banks - 1982 to 1987
($ millions)

COUNTRY	1982	1983	1984	1985	1986	1987
ARGENTINA						
Exposure	3,105.8	3,150.1	2,868.7	2,535.9	2,597.0	2,517.0
% of Capital	7.5%	6.6%	5.2%	4.0%	3.7%	3.2%
% of Assets	0.5%	0.4%	0.3%	0.3%	0.3%	0.2%
BOLIVIA						
Exposure	147.0	114.7	93.0	5.2	2.0	77.0
% of Capital	0.4%	0.2%	0.2%	0.1%	0.1%	0.0%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0
BRAZIL						
Exposure	7,141.3	7,354.1	8,068.3	7,845.5	7,046.0	6,268.0
% of Capital	17.2%	15.4%	14.5%	11.5%	10.2%	8.1%
% of Assets	1.1%	1.0%	1.0%	0.8%	0.7%	0.6%
CHILE						
Exposure	2,753.9	2,762.0	2,873.5	2,502.0	2,313.0	1,991.0
% of Capital	6.6%	5.8%	5.2%	4.0%	3.3%	2.6%
% of Assets	0.4%	0.4%	0.3%	0.3%	0.2%	0.2%
COLOMBIA						
Exposure	970.3	1,075.9	785.2	701.6	620.0	679.0
% of Capital	2.3%	2.2%	1.4%	1.1%	0.9%	0.9%
% of Assets	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
ECUADOR						
Exposure	876.6	857.5	808.9	777.3	812.0	677.0
% of Capital	2.1%	1.8%	1.5%	1.2%	1.2%	0.9%
% of Assets	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
IVORY COAST						
Exposure	153.0	141.5	137.7	105.2	91.0	62.0
% of Capital	0.4%	0.3%	0.2%	0.2%	0.1%	0.1%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
MEXICO						
Exposure	11,515.1	12,210.5	11,831.6	10,847.0	10,301.0	9,371.0
% of Capital	27.7%	25.5%	21.3%	17.2%	14.8%	12.1%
% of Assets	1.7%	1.6%	1.4%	1.2%	1.1%	0.9%
MOROCCO						
Exposure	167.6	146.3	198.5	247.3	205.0	144.0
% of Capital	0.4%	0.3%	0.4%	0.4%	0.3%	0.2%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
NIGERIA						
Exposure	405.6	534.7	392.3	295.1	236.0	171.0
% of Capital	1.0%	1.1%	0.7%	0.5%	0.3%	0.2%
% of Assets	0.1%	0.1%	0.0%	0.0%	0.0%	0.0%

(continued)

TABLE 3. U.S. Bank Exposure in the 17 Highly Indebted Countries
Non-Money Center Banks - 1982 to 1987 -- continued
($ millions)

COUNTRY	1982	1983	1984	1985	1986	1987
PERU						
Exposure	1,176.8	1,142.4	1,061.5	697.9	526.0	416.0
% of Capital	2.8%	2.4%	1.9%	1.1%	0.8%	0.5%
% of Assets	0.2%	0.2%	0.1%	0.1%	0.1%	0.0%
PHILIPPINES						
Exposure	1,863.9	2,130.7	1,697.6	1,627.5	1,404.0	1,399.0
% of Capital	4.5%	4.4%	3.1%	2.6%	2.0%	1.8%
% of Assets	0.3%	0.3%	0.2%	0.2%	0.1%	0.1%
URUGUAY						
Exposure	308.5	281.1	274.4	199.1	231.0	243.0
% of Capital	0.7%	0.6%	0.5%	0.3%	0.3%	0.3%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
VENEZUELA						
Exposure	3,771.4	3,621.6	3,377.5	2,962.8	2,605.0	2,497.0
% of Capital	9.1%	7.6%	6.1%	4.7%	3.8%	3.2%
% of Assets	0.6%	0.5%	0.4%	0.3%	0.3%	0.2%
YUGOSLAVIA						
Exposure	858.7	875.3	876.7	875.9	750.0	667.0
% of Capital	2.1%	1.8%	1.6%	1.4%	1.1%	0.9%
% of Asset	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
"BAKER PLAN" 15						
Exposure	35,215.5	36,398.4	35,345.4	31,674.3	29,789.0	27,129.0
% of Capital	84.7%	76.0%	63.7%	50.2%	42.9%	34.9%
% of Assets	5.2%	4.8%	4.3%	3.5%	3.1%	2.7%
COSTA RICA						
Exposure	266.0	261.9	239.0	231.0	204.0	158.0
% of Capital	0.6%	0.5%	0.4%	0.4%	0.3%	0.2%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
JAMAICA						
Exposure	37.6	56.1	82.6	50.4	34.0	29.0
% of Capital	0.1%	0.1%	0.1%	0.1%	0.0%	0.0%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
TOTAL						
Exposure	35,519.1	36,716.4	35,667.0	31,955.7	30,027.0	27,316.0
% of Capital	85.4%	76.7%	64.3%	50.6%	43.3%	35.2%
% of Assets	5.3%	4.9%	4.3%	3.5%	3.1%	2.7%
MEMORANDA:						
Capital:	41,600.0	47,900.0	55,500.0	63,100.0	69,400.0	77,700.0
Assets:	673,000.0	755,000.0	823,000.0	906,000.0	975,000.0	1,007,000.0

Note: Totals do not necessarily add due to rounding.

Source: Prepared by the Congressional Research Service from Federal Financial Institutions Examination Council. Statistical Release E.16(126), Country Exposure Lending Survey. Various year.

eral sense in order to solve the debt problem. Institutions that are involved in the capital market at the present time do not want to extend their participation but in fact want to get out.

The purpose of public policy ought to enable them to get out while making them pay some price for their mistake. We must also replace those flows with larger official flows on the one side and reduced debt service payments on the other.

Mr. DORNBUSH. I'd like to add that it is very common. Colombia has the same problem as Venezuela. Any Latin American country today that tried to roll over principal would find it's impossible to get a voluntary agreement. The only way to get your principal rolled over is not to have the money to do it and to say it has happened. That was common in the 1930's in the same way and in earlier debt crisis, too. I think it simply reflects the fact that in asset markets in developed countries people aggregate Latin America and say it's the region at large, and for the bank stockholder, what matters is total Latin American exposure and if you can't get out of the bad ones, then you get out of the good ones. That means get Venezuela and Colombia to pay back principal.

Senator GRAHAM. One thing that has run through the comments of both panels today is the need to take a combination of a case-by-case approach within some principle structure. Is there an entity available today that has the capacity to carry out that type of act of having some general principles which can then be shaped to the case-by-case needs of a Brazil or a Costa Rica or other countries?

Mr. DORNBUSCH. One is inclined to say the World Bank, but one is immediately skeptical because the one time the World Bank came close to trying to do it with Costa Rica the American executive director was instructed to block any move. And since then, one hears that the World Bank isn't even allowed to think about it any more.

So there is an issue of how strongly the Treasury directly influences it. Of course, that could become a good thing if the Treasury was managed with more farsightedness in these matters. The World Bank certainly has the professional capacity and the experience to do it, the financial experience, no question. All it needs is to be pointed in the right direction.

Senator GRAHAM. Does any other panelist have any comments as to whether there is an entity available today to perform this task or, in the alternative, does one have to be created?

Mr. ISLAM. I would say that not probably one entity alone, but there are entities that can be combined in a new framework which would perform the task. A facility that relies heavily on the banking staff and other regional development bank resources to both develop policy packages as well as arrange for negotiation of the amount of debt relief that is necessary to restore growth and investment in these countries could be very useful.

My own feeling about the World Bank's role, either in terms of taking over the debt management or even being a partial guarantor through some debt bond conversion scheme is that the World Bank is already under the gun—it's a large financial borrower in the international markets and it is under some scrutiny and somewhat tarnished creditworthiness because of its defaulting loans to a

number of countries as well as the organization restructuring that caused some disruptions.

So the World Bank, by taking over the debt management or guaranteeing these bonds, could become part of the problem and not part of the solution.

Mr. DORNBUSCH. I want to add a word of caution about inventing a new organization, borrowing from commerical banks 100 economists because they apparently speak Spanish and having them develop the conditionality for the new programs. The Institute for International Finances which was created in the aftermath of the debt crisis is really a walking example of how that doesn't work.

The World Bank, the IMF, the people who for 30 years have spent a lot of time getting experience, know the problems, know the difficulties, have common sense by now, have gotten rid of all the cliches—those people you would like to use because they are way ahead, not people who are new to it and bring totally bright ideas that then backfire.

There is also a serious issue of who backs the bonds and not to raise the cost of capital to India, but when it comes to designing programs, do use people who have some experience, not the people who made the bad loans.

Senator GRAHAM. Mr. Dornbusch, you made some comments in your opening statement that were slightly less than laudatory of the Morgan plan in Mexico. You indicated that you might be willing to elaborate on that.

Could you talk about that specifically, particularly in the context of what does that say about the current state of public policies incentives to innovative and creative case-by-case solutions to this problem?

THE MORGAN PLAN AND MEXICO

Mr. DORNBUSCH. I would like to say two things. One is that it was counterproductive in that it raised extremely high hopes, that in the early stage of designing the plan people forgot about the fact that unless the new debt has seniority it's no better than the old debt, even if that is covered up with a 20-year coupon bond which we invented in order to avoid income taxes.

Now practically, what is the problem? The problem is that Mexico needs reserves very desperately in order to sustain the exchange rate as growth starts. If they use those reserves to buy back debt, it does little to the interest burdens. It gets down some, but not commensurately with the outlay.

If much of the problem is to get for 5 years the house gradually in order, the last thing one wants to do is to use reserves, pay off debt, which is a one-way street, because certainly they cannot borrow if early next year they need it. So it's much better to keep the reserves, earn interest on them until next year, then maintain with those reserves the exchange rate, hence the wage, hence the political stability, get some investment, and then later start paying interest in dollars and maybe in the year 2400 repay the principal. That is normal reconstruction.

The Mexico deal did exactly the opposite. It says what a wonderful opportunity to buy in the bargain basement back the debt. Now

there is a basic incongruity. If you have a lot of money, then the discount isn't going to be very interesting; and if you don't have money, then of course you can't take advantage of the big discount. Here they are trying to get away from that truth and as a result, of course, crash. Any further deals that say Mexico sits there with $15 billion of reserves, let's get the money before they use it, effectively is a program that stops growth in Mexico and for us is a real political risk. If they cannot hold the exchange rate they can't hold the wage and if they can't hold the wage, then the political institutions really are in peril.

If you take someone who can't pay interest and say why don't you pay off your debt somehow doesn't sound right. To take a farmer and say, "You know you ought to sell your tractor" doesn't sound right. Soon we will see the leasing business get in. We should really be very, very reasonable and say the very first thing they need to do is keep any penny they have for reasonable, serious, conservative domestic investment programs. And if they can have it, then the economy normalizes. When it becomes normalized, people bring back their money and that's when you start talking about paying interest and somewhat later paying principal.

The Morgan plan did it exactly the other way around and said, "We have great experience with junk bonds. We'll do a refinancing on you and you will be way ahead." Of course, the Mexicans realized they are not. The next round tried without guaranteed interest payments and it would still be a mistake.

Mr. ISLAM. May I add a point to what Professor Dornbusch said? I very much agree with his conclusion. I would just add that there's a lesson also for this Mexican-Morgan plan, what people have called M&M plan, for other countries. I think one of the major problems of this sort of approach is it's very marginal and it's very uncoordinated. That means you begin with some interest reduction which is not happening in the first year but it happens the second or third year but it doesn't make any difference to the country's overall debt service capacity. And that is one reason why this plan wasn't successful. Mr. Wagner was asked why didn't it work very well. Well, one reason it didn't work is the banks wanted interest guarantees. They care about the next year's payments, not what they're going to get in 20 years.

The reason the banks didn't believe the interest risk was reduced is because it was of too little benefit to the banks themselves. The market itself sort of showed that this kind of plan is not reducing the default risk because of the marginal and uncoordinated approach to debt reduction.

Mr. FISHLOW. Could I just add two items? One is that refinancing only works if you refinance a lot and very favorably, and that clearly did not happen in the Mexican case.

The second point is that in dealing with principal, as one does with debt-equity swaps, for example, one is really paying off in advance the principal that otherwise is being rolled over. So that when you have a debt-equity swap, you're taking a loan that you would not under ordinary circumstances have to pay and you are now paying it off, admittedly in domestic currency. But you still have to get the domestic resources that correspond to the domestic currency for the program to be effective.

You're creating a situation in which your payment is due in the year 2000 and you have to make it today. In order to make it today, you have to get the domestic resources to correspond to that payment, which can be an overload on that domestic economy.

Mr. DORNBUSCH. Could I add a remark to something that was said earlier, and I think Mr. Fishlow agrees with me on this. It was said that equity investment in Latin America is severely restricted. I think that is factually incorrect. Certainly anyone who looks at Brazil's industry can't help but be amazed by the fact that 30 percent is foreign owned. The Mexicans are in the process of eliminating totally legislation that requires a majority domestic ownership. There is an enormous freedom on direct foreign investment in Latin America today. Perhaps the rhetoric is not all outgoing, but the fact of it is totally clear. In fact, it's so clear that countries find they can't sustain debt-equity programs because the stuff comes by itself. So I don't believe that Latin America is extremely hostile to foreign investment. It may be later, but at this time it's an auspicious time not to stop those flows by financial gimmicks.

Mr. ISLAM. May I add one more fact to that fact? The country that is considered the success story right from the beginning is Korea and if you look at the data that is the country with the most restrictive foreign investment. The share of foreign investment in Brazil as a percent of GNP is much, much higher than that in Korea. So I just wanted to point that fact out. People may think Korea is open or they are foreign investment oriented, and that may be the reason why they have done better, but I don't think equity or foreign investment are the reasons why a country does well or does not well.

Senator GRAHAM. As the last question that I would like to ask, what lessons do you think we have learned from the experience of the last 15 years that ought to be incorporated into any public policy initiative that we take in dealing with current circumstances and attempting to create an environment which we will not replicate?

LESSONS LEARNED FROM EXPERIENCE OF LAST 15 YEARS

Mr. FISHLOW. Well, I think in the first instance, we have learned that leaving the market to work its magic in the area of lending in the 1970's leaves a residual behind, that the market does not work perfectly in this particular area, that the sources of the resources were not compatible with the development uses to which they were put.

I think the second lesson that we learned is that developing countries were overeager to become indebted during this period of time, relied too heavily on the public sector and public guarantees in order to do so, and thereby distorted their own internal economies. This is a lesson which most debtor countries are quite cognizant of as they try to design new policies in an effort to return to sustained economic growth. It is quite ironic that private American banks underwrote the enormous expansion of the public sector in most of the Latin American countries in a way that would have been impossible on the basis of domestic resources.

I think the third lesson that we've learned is how difficult it is to resolve the debt problem absent a major crisis. It has already taken 6 years and a considerable loss in output in developing countries that will not be regained in order for us to get to the point of recognizing that something else must be done. Public policy is very slow to react, particularly in the international economic area, and that means a more conservative but consistent policy over a longer span of time probably works best. Large departures, whether in debt or exchange rates, should have been discouraged.

Mr. DORNBUSCH. I would agree with every word. To reemphasize, the unregulated lending is totally endemic to financial markets. Every debt crisis of the last 150 years was too much lending and when anything happened—say the country's export prices fell—they couldn't get the new loans to pay the interest on the old, and that was a debt crisis. This one was no different.

How do you stop that? Well, you probably have to trim the pace of debt lending for development and force much more equity lending which is a point I was trying to make in the earlier session today.

The second one, any time you see an overvalued exchange rate in the United States or elsewhere, don't believe it's an economic miracle; think it's mismanagement.

And the third, looking ahead, is that we must not make the mistake now to think that the debt problem is an accounting problem or a financial problem. It's a problem of investment, economic reconstruction. There's no way to take someone who's bankrupt, securitize him, and send him off at a profit and everybody coming out ahead. I emphasize everybody. The guy who can actually sell it might well make a profit. There is an extraordinary temptation to look for financial gimmicks in this situation what one really wants totally reasonable reconstruction, not financial treatment.

Mr. ISLAM. I would like to echo some of the same points, but very briefly. I think a point was made by Mr. Nicholson, a banker himself, very forcefully that the biggest mistake—and that is probably the biggest lesson—banks made was to get involved in providing more and more balance-of-payments, general obligation loans to countries. This is a business the banks were not familiar with. They didn't know how to value the risk, but they were much praised by the international community to do so. So the banks overlent, and countries overborrowed, and that was a sin committed by consenting adults.

I think the problem with that is that we have found out that there is no international chapter XI for working out a default situation. So that's why you have 6 years gone by and you haven't been able to get either the countries or the banks out of this debt mess.

Finally, I would say that what banks have gotten into now is from recycling the Arab money to Latin America into recycling their own money into Latin America, and I think the lesson that any facility or a solution should take in is to avoid that in the future. That is why I keep emphasizing that one of the criteria for the discount on the debt has to be such that banks will be completely weaned out of this balance-of-payments loans business. They don't want to do it. They don't know how to do it. They are

now very unhappy that they have done it, and they want to get out of it. The balance-of-payments loans for unforeseen circumstances should be given by the IMF. The structural adjustment type of loans should be given by the World Bank, and the banks should go back to their original division of labor of lending trade credit and perhaps some low-risk project loans and other types of business.

Senator GRAHAM. Would you suggest, for instance, that the Federal Reserve Board should modify its regulation as it relates to acceptable lending practices by American commercial banks?

Mr. ISLAM. I think they should, but I would make a broader point. If there's any benefit one should get out of this debt problem which should be—perhaps it's a naive hope—is to have some reregulation of bank lending internationally, especially to sovereign governments, that would avoid such things in the future. I, of course, don't know how much of that could be done, but I would say in this process of the efforts to regulatory reform perhaps some of the issues about bank lending to sovereign governments for general obligation loans versus project loans or trade loans could be considered.

I think a philosophy one should follow is that banks get into trouble when they start financing budget deficits of a country. They should stick to financing things that they know how to finance.

Senator GRAHAM. Mr. Rona has something to say.

Mr. RONA. Thank you, Senator. It's a pity that the professor has such a liking for polemic imprecisions, but as far as my testimony was concerned, I said, first of all, in regard to Mexico, I did not mention Mexico specifically except to say it is factually untrue that Mexico is inhospitable to foreign investment on the basis that it is now changing its laws to becoming more hospitable is not quite the same thing. If it is changing its law it is actually becoming hospitable.

Mr. DORNBUSCH. That's splitting hair. IBM has a fully owned, no sharing whatsoever, operation in Mexico.

Mr. RONA. As far as Brazil is concerned, there are serious questions about patents and industrial property rights in Brazil that are significant factors for investments in their country and those matters have not been changed.

Mr. DORNBUSCH. Is that why IBM is trying to get into Brazil? I must confess, Mr. Chairman, that I am baffled by what we are here told. I live in Brazil 2 months a year and Mr. Fishlow is probably the leading Brazil expert, and when we heard Mr. Rona we were surprised by the strength with which he said that equity investment wasn't being allowed as freely as he might wish.

Senator GRAHAM. Could I make a suggestion? Could we request both sides on this issue to supplement their remarks with whatever quantification they would like to submit to support their position and those millions of people who will then read the results of this hearing record will be able to come to their own conclusions.

I want, on behalf of Senator Proxmire and Senator Sarbanes, to express our collective appreciation to both panels for the excellent presentations and the insights. The areas of disagreement are maybe as illuminating as those where there was consensus. I consider this to be one of the major challenges to our Nation's ability

to provide effective economic and political leadership internationally and internal discipline in terms of how we will respond to the current circumstance and dealing with the future that will be on the agenda of the next President.

One of our goals in these hearings is to help define what that agenda item should be and what the range of options are so that in what I feel to be the short time available for an effective response the new administration can use that time as positively as possible.

Thank you for your contribution to that goal.

[Whereupon, at 1:20 p.m., the hearing was adjourned.]

[Response to written questions follow:]

James D. Robinson III
Chairman and Chief Executive Officer
American Express Company
September 14, 1988

Question from Senator Graham:

"Please discuss the distinction between how we treat (both from our country's perspective as well as the banks' perspective) old debt and new debt, and which of those represents the most appropriate lever to secure internal economic reform in the LDC."

Answer:

Under our initial proposal for dealing with the debts of the less developed countries, the "old" debt of an LDC owed to banks would be bought from the banks at a discount from face value by an new international entity, which we called the Institute of International Debt and Development (or I2D2). In exchange, the banks would receive a combination of bonds and stock issued by I2D2, with interest and dividends financed by the reduced debt service payments of the LDC. Should there be any cash flow short fall, which there might well not be, I2D2's debt would be backed by a reserve fund or guarantee provided by the industrial countries.

The new entity, or I2D2, would hold the "old" debt of the bank loans at face value. However, its own debt service obligations would be reduced since it bought the debt at a discount from face value -- say, $60 of I2D2 securities exchanged for every $100 of bank loans at face value. Thus, in practice, I2D2 would provide substantial debt relief through interest payment reductions and deferrals of principal repayment.

While we have assumed that most of the financial relief to the indebted LDC would occur initially through debt service reductions, "new" debt, or new lending, would occur for the LDC through two processes. First, the international institutions such as the World Bank and the various development banks would continue to provide loans to the LDC. Second, the debt held by I2D2 could be subordinated to new loans from banks, giving those new loans prior claim on resources. Coupled with the adoption of economic reforms by the LDC as part of the financial relief agreement, debt subordination should attract new lending, and over time lead to a growing volume of new private-sector loans to the LDC to finance trade and development projects.

In terms of leverage over internal economic reforms by the LDC, I2D2's debt relief on old debt and its subordination of old debt to new credit both play a role. To be eligible for consideration for debt relief under I2D2, LDCs must have already demonstrated commitments to reforms in these areas, as well as good-faith efforts to service existing debts. As part of agreements to provide debt relief, the LDCs must take steps to accelerate policy reforms. To help ensure continuing commitments to reforms, both debt relief and debt subordination would be subject to suspension or limitation for poor performance by the LDC. Since any debt relief in practice would be difficult to withdraw except for egregious violations of agreed-upon conditions, limits on new credit would provide the most effective ongoing discipline. Loans from the World Bank and other development banks could be held up, for example. Caps on how much new credit from banks would be subordinated also could be raised or lowered depending on the LDC's implementation of economic reforms.

RESPONSE TO WRITTEN QUESTION OF SENATOR GRAHAM FROM
EUGENE ROTBERG

Question from Senator Graham:

Please discuss the distinction between how we treat (both from our country's perspective as well as the banks' perspective) old debt and new debt and which of those represents the most appropriate lever to secure internal economic reform in the LDC.

Response:

First, there is no consistent usage or understanding of the term "old debt" versus "new debt." For example, assume that a country has $100 billion of external indebtedness and that the interest rate is 10%, therefore requiring a debt service payment of $10 billion per annum. Assume further that the banks provide during the year, say, $5 billion, with the clear proviso that that $5 billion would be paid to the banks on the interest payment dates for the old loans, and that the country would supply the balance of the $5 billion of interest due from its own resources. From the country's point of view, that is not considered "new" money, since it represents a convenient way for the banks to accrue, as interest income, $10 billion a year, even though the banks themselves are providing $5 billion back to themselves. The borrowing country would argue that none of these funds were used for development, nor to facilitate growth or productivity and that unless loans made by banks were in excess of the amount of the interest and principal due at any given year would the loans be considered "new."

From the banks' perspective, however, there is increased

credit exposure in the country -- it increased from $100 billion to $105 billion and, indeed, their outstanding loan account will show loans in the latter amount. The fact that the funds may have been lent "involuntarily" is not relevant to the banks' risk. Banks do not distinguish "new" money versus "old" money. They simply look at what their exposure is and the prospects for (a) being repaid principal; (b) receiving interest without increasing their own exposure through additional lending to facilitate that payment.

The banks would also argue that the $5 billion represents "new" loans, not only because they have increased their exposure, but because the payment freed up $5 billion from the country's resources to be used for productive purposes. The borrower, of course, in contrast, argues that is not the case, and that if the banks had not lent $5 billion, they would have received only $5 billion from the borrower, or half of the debt service that was due. The borrower would argue, therefore, that the lending by the banks was purely an accounting convention to facilitate a desire to book $10 billion in current income as income received.

It is my view that the debate on this issue is not a meaningful one and that the key is whether or not funds lent by banks (or the World Bank or the IMF), irrespective of how these are accounted for, are linked to fundamental structural reform in the country. It matters little, since all money is fungible, whether the lending is targeted or not to specific projects or

purposes, so long as there is leverage, control and fundamental structural economic reforms agreed to and maintained as a condition to the "new" loans. While it is conventional to tie economic reforms or even specific targeted projects (e.g., imports needed for replacement parts), that is merely for political convenience, for all the participants know that the key factor is whether the country's economy is being managed consistent with principles which the external suppliers of funds find acceptable. The "tag" that is put on the so-called "new" money is simply used to argue that these particular funds are going for a wise purpose (a perfectly acceptable pretense, since funds cannot be traced) and it doesn't really do any harm to "tag" the "new" loans, so long as the country's overall performance and reforms are consistent with appropriate economic policies.

It is my sense that the leverage that is needed to encourage or insist on those wise economic programs are immeasurably assisted when they are linked to additional resource transfers from banks or multilateral agencies, as distinguished from so-called debt reduction schemes. Debt reduction occurs all of the time -- both voluntarily and involuntarily. For example, of the $220 billion of debt (which matured during the period 1983 - 1987) owed by the Baker 15 countries, less than $15 billion was actually paid. The remaining debt -- in excess of $200 billion, was "restructured" over a 20 - 25 year period. That is debt relief. In addition, banks lent another $45 billion in this period, involuntarily, and by so doing, increased their exposure as a form

of debt relief, since, to that extent, it removed the obligation of the borrowers to meet, out of their own resources, their full debt service obligations. Further, many countries are now paying no interest at all and still others are paying at a rate well below the current market rates. All of this is debt relief, yet little of it has been linked to structural economic reform. The reason is simply because countries who "save" money by not paying interest or principal, or who receive "new" funds as balance of payment support to facilitate commercial bank accruals of income, are not easily amenable to leverage or pressures. The savings from debt reduction, or debt relief, or debt forgiveness, are "lost in the rounding," with little possibility by multilateral agencies or the banks to exercise leverage or get credit for the debt reduction. New funds, however, particularly if systematically linked to structural reform programs, consistently have conditions, qualifications, tranching, which offer far more leverage well beyond the subject project or program to which it is linked.

In short, while some of this may be psychological, there is little doubt that the politics is such that lenders have more leverage when they lend $2 billion than when the borrower unilaterally takes a step not to pay $2 billion (or even if the borrowers "agree" not to "insist" on the payment), though the cash flow implications during that year may be identical.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
EUGENE ROTBERG

Questions from Senator Heinz:

a) Have the conditions underlying the present strategy of restructuring with new lending changed fundamentally?

b) Is it inevitable that the banks will further reduce their LDC lending leaving the LDCs to rely on their own resources and multilateral institutions for investment capital?

c) Are banks more or less likely to favor comprehensive debt facility approaches under these new circumstances?

d) Is debt reduction likely to grow in importance, a la the Morgan plan, whether or not a facility is established?

Response:

Much of what I have said in my earlier response applies to the issues raised by Senator Heinz. I also would add the following:

1. Banks don't want to lend to heavily-indebted LDCs. They are gaining increasing leverage in that respect because they have provisioned against loans and taken losses and, therefore, it is increasingly difficult for the borrowers to pressure the banks into lending. I believe that the trend will be for banks to lend lesser percentages of the interest that is due to them, particularly in countries where the indebtedness is rather small and where the banks can afford to take the accounting hit. I see little prospect for new voluntary commercial bank lending to the

so-called Baker countries, and virtually no prospect for those countries entering capital markets on a consistent or substantial basis.

Banks would, understandably, favor a comprehensive debt facility if, one way or another, they were subsidized, guaranteed or taken out of the obligations on their old or new loans. The distinction between old debt and new debt, again, is not a meaningful one, since the new money, if guaranteed, would simply be structured as interest to assure that payments were made on the old debt. Banks, however, are increasingly skeptical whether they will be protected through the use of guarantees on "new" loans which will be used to make safe their old debt -- so long as they remain solvent.

As for debt reduction, there has been a great deal of it already (see my answer to Senator Graham). What we have not seen is debt forgiveness. Most developed countries would prefer debt forgiveness, since that politically can be used domestically far more effectively than debt reduction -- a unilateral act which casts the borrower in a rather hostile position if it is accomplished by simply not paying interest or principal. If debt reduction is, of course, bilaterally agreed to, e.g., the Morgan proposal or the Bolivian or Chilean buy-backs, then there is little hostility, but I suspect such schemes will be rather minor in their significance, since the borrowers have little resources to execute such programs.

2. As stated above, I believe that new lending is the key issue, not debt reduction. But, I would not use a World Bank guarantee as a form of credit enhancement. I would use the guarantee of an affiliate. The difference is extremely important, and unless the difference is recognized, the executive branch of the U.S. government is unlikely to support any credit enhancement proposal. My point is quite simple: (a) banks are not likely to lend voluntarily: (b) they will lend if there is credit enhancement or guarantees; (c) the credit enhancement must not involve a call on U.S. taxpayer or the callable capital of the World Bank; (d) a credit enhancement scheme can be developed which will satisfy the banks without running afoul of the constraints in (c).

3. The proposal I have suggested, under no condition, would "apparently fully guarantee all new lending to all debtors," as your question indicates. First, it would not fully guarantee anything. Nor would it guarantee all new lending. Nor would it guarantee all debtors. It would guarantee the principal only, and even then with considerable costs to the banks if the guarantee were used, and further, only for specific kinds of loans, focused on fundamental structural reform in the country, and even then, only to debtors who first met all of the conditions required by both the IMF and the World Bank as a condition precedent for the loans.

The setting up of an affiliate would not call on the U.S.

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callable capital (as you know, the World Bank guarantee is counted precisely the same way as a loan by the Bank, and is, therefore, an extremely inefficient use of scarce guarantee capital). The setting up of an affiliate, however, not backed by U.S. callable capital, but funded out of the liquidity of the bank, would be far more leveraged with considerably greater flexibility, less potential adverse financial market impact on the Bank, and far more politically acceptable. The key is to fashion an entity which is strong enough to encourage the banks to lend under programs linked to IBRD and IMF structural reform, without creating an unwise public policy precedent whereby the U.S. taxpayer or the World Bank callable capital is put at risk. I am convinced that can be done. It is not difficult and I believe it provides a way to break the current impasse which exists between the banks, the U.S. government, the LDCs and the multilateral agencies.

Question for Rodrigo Botero from Senator Graham
August 2, 1988

Q.1. Please discuss the distinction between how we treat (both from our country's perspective as well as the banks' perspective) old debt and new debt and which of those represents the most appropriate lever to secure internal economic reform in the LDC.

The
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September 30, 1988

The Honorable Paul Sarbanes
United States Senate

Dear Senator Sarbanes:

Because of my moving from Duxbury to Cambridge I reply with some delay to your letter of September 6. I refer to Senator Graham's question.

Any reduction in the existing debt-burden of the highly endebted countries would imply the acceptance of a loss to the creditor institutions. To a certain extent that loss has already taken place, as reflected in the market price for developing country debts that some banks are selling at a discount. A negotiated, cooperative solution would recognize that reality and attempt to make an adequate assignment of the cost to the different actors.

That negotiation, (concerning the old debt) would require a serious commitment to economic reform on the part of the debtor countries that chose to participate. Concessions with respect to old debt would be the leverage to induce a negotiated reform program, subject to monitoring.

Towards the future, the process of economic reform and restructuring would be evaluated periodically by a mutually accepted international organization. The flow of additional resources would be tied to the progress of the reform program. The conditions of the new loans (interest rates, grace periods and maturities) would be designed in such a manner as to both encourage and facilitate the economic recovery of the debtor countries. The new loans would probably require greater participation of official lenders such as the World Bank and the InterAmerican Development Bank. The new loans would also constitute an incentive for reform after the initial negotiation is completed.

Both the old debt and the new debt provide leverage for reform. The relative importance of each will vary depending on the specific circumstances.

Yours sincerely,

With best personal regards,

Rodrigo Botero

Question for Peter Nicholson from Senator Granam
August 4, 1988

Scotiabank
THE BANK OF NOVA SCOTIA

General Office, 44 King Street West, Toronto, Ontario, Canada M5H 1H1

P.J. Nicholson, Senior Vice-President and Executive Assistant to the Chairman

September 27, 1988

Paul S. Sarbanes
Chairman
United States Senate
Committee on Banking, Housing
and Urban Affairs
Washington, DC 20510-6075

Dear Senator Sarbanes:

I am writing in response to your letter of September 6 in which you asked on behalf of Senator Graham for an elaboration of my views on the following question:

> "Please discuss the distinction between how we treat old debt and new debt and which of those represents the most appropriate lever to secure internal economic reform in the LDC."

This question goes to the heart of the debt strategy and involves a number of important subtleties which I have outlined in the short paper which is attached.

In the context of today's bank lending to heavily indebted LDCs there is no real difference between the terms applied to new and old (i.e., rescheduled) debt. New and existing lending are linked inextricably since all new commercial bank credit (other than short-term trade finance) is being offered essentially to keep interest payments current on existing debt. New lending is therefore not voluntary in the usual sense but is part of a strategy promoted by creditors (and creditor country governments) to buy time while capital and reserves are built up and in the absence of any more constructive approach. In these circumstances lenders have limited leverage in forcing the governments of indebted countries to adopt a particular program of policy reform.

The treatment of existing debt by creditors affords an opportunity to offer negotiated relief, if necessary, and thus to reward a country for making the sacrifices required by a tough reform program. The relief also reduces the resource transfer and amplifies the economic effects of policy reform thus reinforcing the reforms. But if the country fails to adhere to an agreed reform program there is little leverage in the threat to withdraw concessions since the country is then likely to default. The only effective reprisal available to the lender is to refuse to provide new credit.

Thus to sum up -- an effective strategy to promote and to sustain economic policy reform in heavily indebted LDCs must involve treatment of both existing and new debt in a mutually reinforcing way. In simplest terms; negotiated concessions on existing debt service can help to motivate reforms whereas the power to withhold new lending provides creditors the leverage to encourage adherence to the reforms. In this regard, the future role of commercial banks will primarily be to provide (or to withhold) short-term trade credit while official lenders must be relied upon for medium- and longer-term lending and to apply the potential discipline associated therewith. The conclusion is that while external creditors have some leverage to encourage policy reform in borrowing countries it can never be truly effective in the longer run if the country itself is not strongly committed to the reforms.

I wish to thank you again for having given me the opportunity to appear before your Sub-committee. If you have any further questions I would be more than pleased to attempt to answer them.

Sincerely,

P.J. Nicholson

Encl.

September 26, 1988

INCENTIVES FOR LDC POLICY REFORM: OLD DEBT VS. NEW DEBT

A constructive approach to the developing country debt problem must address three related issues: the supply of new credit; possible concessions regarding the service of existing debt; and a sustained commitment to economic policy reform by the debtor country. The challenge is to design the most effective means by which the promise of new credit and the treatment of existing debt can be employed as incentives for the country to persevere with policy reform notwithstanding the inevitable political difficulty.

1. The governing authorities in the country must genuinely believe that the reform program serves the national interest. Although various "carrots and sticks" can be administered by external creditors, these can only be of short-term effectiveness if the underlying objectives are not shared by the local authorities.

2. Regarding the leverage of creditors over debtors, the treatment of existing debt is fundamentally different from the treatment of new lending. In the first case, the money has already flowed and the objective of the lender is to be repaid. This affords leverage to the borrower. Conversely, the prospect of new lending affords leverage to the creditor but once the new money flows the creditor becomes concerned with repayment and leverage begins to shift to the borrower. There is thus a constant interplay between new and old credit.

3. Creditors can encourage policy reform in a debtor country by:

   (a) offering concessions on existing debt. This can be portrayed by local authorities as a reward for sacrifice and may thus build political support. Also, the concession reduces the external transfer of financial resources and thus amplifies a reform program and improves its chance of success; or

(b) offering new credit. This is equivalent in effect to concessions but may be less desirable, all else being equal, in countries where debt ratios are already excessive. (Revolving trade credit will in any event continue to be needed.)

4. Once a reform program has been agreed and launched -- perhaps in response to external encouragements as described above -- the challenge is to avoid backsliding. If the country's commitment falters:

(a) concessions that may have been granted in respect of existing debt can be withdrawn. But this is largely ineffective in practical terms since the non-compliant country will presumably have reduced economic capacity to service its debt and will likely be forced to default;

(b) new lending can be withheld. This is a potent discipline especially when trade-related credit is withdrawn as, for example, Peru and Brazil discovered. And since short-term credit continuously recycles, the threat of its removal is a constant and measured incentive to encourage adherence to reform policies.

5. The ability of a creditor to withhold new money is thus the only truly effective discipline that can be applied to a debtor country. But in practice there may be significant limits on the use of this discipline. The cases of lending by official sources and by commercial banks should be distinguished.

(a) When long-term lending for a project is being arranged -- usually involving the World Bank or affiliates -- there is an opportunity to negotiate an agreement on economic reform in the borrowing country. The loan can be disbursed in phases ("tranches") with each successive one depending on

satisfactory economic performance by the country. But even if performance turns unsatisfactory it becomes increasingly difficult to withhold future tranches for fear of destroying the entire project and therefore the ability of the borrower to service the debt already incurred. Thus good money may be sucked in by bad.

(b) Although the ability to withhold new money may appear to afford banks leverage over the economic policies of heavily-indebted LDCs, often the leverage is reversed. Most banks will not consider voluntary new lending in any event (except possibly short-term, self-liquidating loans for trade, etc.) The so-called "new money" negotiations which have been a central component of the prevailing debt strategy are encouraged by lead banks primarily as a means to ensure continued service of existing loans. The real supplicant is the creditor seeking to keep payments current while a cushion of reserves and capital is acquired. This "involuntary" lending actually reflects the considerable leverage of the indebted country and reduces the credibility of any threat to withhold new money if the country strays from the path of policy reform.

6. There are further limits, in practice, on the degree to which control of new money can serve as an effective discipline. When new loans are sought from official sources (e.g., IMF, World Bank, export credit agencies) there will always be political considerations which may attenuate the lender's willingness to enforce tough conditions. For example; agencies may vie among themselves and the extension of export credit will always be motivated by the lender's self-interest. Moreover, failure by a country to adhere to an economic reform plan is rarely a black or white issue. There are always extenuating circumstances. For example; there may be technical shortcomings in statistics and their interpretation. Experience may show that targets were unreasonably ambitious. Improvement may appear to be just around the corner. When these factors interact with a host of political

motivations -- both of creditors and of debtors -- the potential discipline associated with new lending programs can be significantly diluted.

7. The situation is simpler if the potential lender is a commercial bank since the objectives are more purely economic. But it is difficult to unite banks in co-ordinated support of a policy reform program in a borrowing country. Banks behave competitively and are understandably hesitant to become explicitly involved in political issues among governments. And while commercial lenders will certainly base credit decisions on a view of the borrower's economic management they will be reluctant to actively intervene to force a particular policy approach. This is the domain of governments.

In summary -- negotiated concessions in respect of existing debt service can encourage a country to persevere with politically difficult policy reforms and can amplify the effectiveness of such reforms. But it is the ability to withhold new money that provides creditors with the only effective leverage to enforce continued commitment to a reform plan. It is essential to distinguish between voluntary and involuntary new lending. The former confers leverage to the lender; the latter to the borrower. Banks will not lend longer-term funds voluntarily to heavily indebted LDCs (unless the loans were guaranteed) so the only leverage that can be exerted by banks is with respect to providing (or withholding) short-term trade credit. Official lenders may be able to exert discipline in connection with medium- and long-term lending. But the leverage associated with disbursement of such funds is, in practice, less than it appears to be in theory. Thus while concessions regarding existing debt and conditions associated with new lending are important incentives for a borrowing country to adopt better economic policies, these incentives can never be truly effective in the longer run if the country itself is not committed to the reforms.

RESPONSE TO WRITTEN QUESTION OF SENATOR GRAHAM FROM
PETER RONA

country's perspective as well as the banks' perspective, old debt and new debt and which of those represents the most appropriate lever to secure internal economic reform in the LDC.

Echoing somewhat a distinction embodied in the bankruptcy laws, sovereign risk lending distinguished between old debt and new debt up until the Polish debt crisis in 1980 at which time the distinction was for all practical purposes abolished. Bankruptcy law makes a distinction between debtor-in-possession financing and credits extended up until the filing of the bankruptcy petition. The former is given a priority over the latter. In a somewhat similar vein, trade financing was traditionally exempt from sovereign risk restructurings. Until the 70's of course most less developed country financings took the form of bond flotations rather than long term bank lending and when the bonds were defaulted upon negotiations took place with the bond holders. By contrast trade financing was provided by the commercial banks and as long as the banks continued to finance trade with the defaulting country, they did not participate in the restructuring. At no time in the past or in the present, however, have there been any legal distinction between old debt and new debt in LDC lending in the sense one finds it in the bankruptcy laws. As a consequence there is no reliable way to negotiate on the basis of such a distinction. Even if embodied in contractual provisions such distinction could not be protected against a challenge by third parties. This absence of a legal basis for

distinguishing between old debt and new debt remains an important impediment to progress in restructuring LDC debt.

While much of the less developed world could greatly benefit from internal economic reforms (the magnitude of flight capital is eloquent proof), the debt crisis does not seem to be a particularly conducive means for bringing about such reforms. There are a number of reasons for this. First, as already mentioned, the distinction between old debt and new debt is vulnerable from a legal point of view. Second, the plain fact is that the commercial banks seriously over-lent to LDC's, and no amount of reform can rehabilitate these ill conceived loans. The third is that fundamental justification for internal economic reform must come from the internal social, political and economic realities of the country involved and not from the exigencies of foreign bankers. Reform is always difficult, but it will be particularly difficult if the beneficiary is seen not to be the country undertaking such measures, but, rather, its foreign creditors.

Question for Albert Fishlow from Senator Graham
August 4, 1988

Q.1. Please discuss the distinction between how we treat (both from our country's perspective as well as the banks' perspective) old debt and new debt and which of those represents the most appropriate lever to secure internal economic reform in the LDC.

Old debt is a given. In addition, in most countries, it is in the hands of the public sector. To service that debt requires taxation, either explicit or implicit, as in the inflation tax. The real asset counterpart either already exists to provide those revenues or it does not.

New debt, on the other hand, corresponds to incremental real resources. They can provide the basis for expanded investment, and hence future increases in production and productivity. Or that inflow can be diverted to service of the old debt, with consequent much lesser impact. Then new debt does not have a better basis for repayment than the old, and the problem simply is aggravated.

New debt can work as a solution only if it is large and part of a coherent development strategy, and if initial debt is not already so great as to impede effective use of the additional debt. These requirements expose the limitations of the Baker Plan. By defining debtor country needs at too low a level, even for countries that might profitably use new debt, the targeted inflows provide insufficient resources for real investment as opposed to service of past debt. (And of course, even these levels were never realized.)

In the absence of adequate supplies of capital, the focus inevitably shifts to debt reduction as a means of lowering net resource outflows and providing a basis for sustained recovery.

Question for Rudiger Dornbusch from Senator Graham
August 4, 1988

Q.1. Please discuss the distinction between how we treat (both from our country's perspective as well as the banks' perspective) old debt and new debt and which of those represents the most appropriate lever to secure internal economic reform in the LDC.

Reply by Rudiger Dornbusch to a question from Senator Graham

1. Debtor countries in Latin America do not have an expectation today of a return of voluntary lending. The major reason is that countries like Colombia, having serviced interest in full and having met regularly amortization schedules for principal, is experiencing two facts:

. The debt trades in the secondary market at a significant discount.

. Commercial banks are refusing to roll over maturing principal payments.

Policy makers in debtor countries thus are forced to conclude that voluntary lending is simply not on the horizon. Unless there is an effective seniority for new money, which existing creditors would certainly decline (and did decline in the Mexican exchange offer) new money will only come in the context of involuntary lending or rescheduling.

2. Fiscal reform is the major priority in debtor countries. It is difficult to see countries raising taxes so as to be in a better position to service external debt. the priority for them is increased taxes (and public sector restructuring, including sales of public sector enterprises) to stop the risk of hyperinflation. To create more incentives for these reforms debtor countries should be offered significant postponement of debt service. That implies a need for "new money" by commercial bank creditors.

3. The most effective way to organize rescheduling, in my judgment, is to recycle interest payments. Debtor countries would service their debts (at least in part), but rather than making dollar transfers at the cost of reduced domestic investment, they would have the agreement of the creditors that these funds would be reinvested in the debtor countries. Such a process keeps up pressure for budget correction and the reduction of an inflated public sector, but it avoids that debt service becomes an impediment to growth. The procedure would also create preconditions for more financial stability and thus make more likely the return of capital flight.

4. A debt restructuring facility can help promote adjustment in debtor countries in two ways. The most apparent is to pass on to debtors a reduction in the face value of debt. But there is another important possibility. Claims acquired by the facility can be rewritten to make it state-contingent: i.e. with high oil prices Mexico pays more, Brazil pays less. Part of the debt problem today is result of contracts that are too inflexible and debtors certainly recognize their interest in more flexible service. Needless to say, more flexible debt service enhanced economic performance.